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FOLLOW-UP AND REVIEW OF THE IMPLEMENTATION OF THE FINAL ACT OF UNCTAD VII IN ACCORDANCE WITH BOARD DECISION 350 (XXXIV): SELECTED ISSUES REQUIRING ATTENTION BY THE BOARD

SERVICES WITHIN THE MANDATE OF UNCTAD AS DEFINED IN THE FINAL ACT*

The problematics of trade in services and technological change

Report by the UNCTAD secretariat

* See proceedings of the Conference for statements made in connection with the adoption of the Final Act of UNCTAD VII.

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CONTENTS

Chapter	*Paragraphs*
Introduction	1 - 2
I. The set of problems confronting the liberalization of trade in services	3 - 100
A. Market Issues	7 - 50
1. Services in the economy and the impact of trade	7
2. Employment	8
3. Balance of payments	9 - 11
4. Services and competitiveness in good	12 - 21
5. Market structure	22 - 28
6. Comparative advantage	29
7. Competitiveness of service firms	30 - 39
8. Concentration of ownership	40 - 45
9. Strategic importance of particular sectors	46 - 47
10. Interlinkages with other sectors	48 - 50
B. Legal and Institutional Issues	51 - 100
1. Regulatory framework	51 - 61
2. Barriers to trade in services	62 - 73
3. Access to information networks and distribution channels	74 - 79
4. Restrictive and unfair practices	80 - 86
5. Barriers to entry	87 - 89
6. Supplier rights and obligations	90 - 95
7. Reciprocity	96 - 97
8. Non-Discrimination	98 - 100
II. Summary and conclusions	101

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INTRODUCTION

1. The Final Act of UNCTAD VII, in its paragraph 105(19), requested the Secretary-General of UNCTAD:

"(i) To analyse the implications of the issues raised in the context of trade in services;

(ii) To explore appropriate problematics for trade in services, keeping in view the technological changes in the field of services."

2. Subparagraph (i) above was addressed in the report on "Issues raised in the context of trade in services" (TD/B/1197) circulated at the second part of the thirty-fifth session of the Trade and Development Board. The present report focuses on subparagraph (ii) and examines the set of problems to be confronted in efforts to establish a multilateral framework for trade in services, consistent with the objectives of progressive liberalization and the expansion and development of the trade of developing countries, and suggests areas where future study is required. In doing so, it addresses both market issues and those of a legal and institutional nature. In both sections it takes account of the new role of services arising from technological advance, which provides the background against which service trade expansion and efforts to liberalize trade in services will take place.

Chapter I

THE SET OF PROBLEMS CONFRONTING THE LIBERALIZATION OF TRADE IN SERVICES

3. The decade of the 1980s has witnessed major initiatives to liberalize trade in services. For example, trade in services has been included in free trade agreements between Canada and the United States, Australia and New Zealand and is an inherent component in the EEC "Single Market" of 1992, and initiatives are being taken among developing countries.[1] In the multilateral context of the Uruguay Round, participating countries have committed themselves to negotiate a multilateral framework to govern trade in services which would aim at the progressive liberalization of trade in services as a means of achieving the expansion of trade and economic growth of all trading partners and the development of developing countries. The essential problematics of trade in services would seem to involve that set of problems which would have to be addressed to avoid conflict among the objectives stated above. Earlier UNCTAD studies, most recently Part II of the 1988 Trade and Development Report,[2] have examined in detail the role of services in the development process. This study, which follows TD/B/1197 presented at the March 1987 session of the Trade and Development Board, examines, in particular, problems that will have to be addressed if liberalization is to be achieved in a manner consistent with the main objective of development.

4. Since the first proposals for negotiations of a multilateral framework for trade in services were put forward in the early 1980s, it has been recognized that effective liberalization of trade in services would be difficult to achieve unless such a framework were to cover all traded services. On the other hand, the view has been expressed that, given the heterogeneity of the services sector, it would be difficult to construct a set of principles and disciplines which could apply equally to trade in all service sectors. The Ministerial Declaration on the Uruguay Round[3] foresaw that the multilateral framework for trade in services could include the elaboration of possible disciplines for specific sectors, particularly in that their application would have different implications in the various service sectors which embody a variety of activities and have very different characteristics. The document incorporating the results of the Mid-Term Review of the Uruguay Round[4] conducted by its Trade Negotiations Committee recognizes that sectoral specificities will have to be taken into account in a number of instances, for example that specific procedures may be required for the liberalization of specific sectors, and that developing countries should have flexibility in choosing which sectors to liberalize. In particular, it was agreed that before the concepts, principles and rules which comprise a multilateral framework for trade in services are finally agreed these concepts, principles and rules will have to be examined with regard to their applicability and the implications of their application to individual sectors and the types of transactions to be covered by the multilateral framework. It was agreed in the same text that this process of examination should begin as soon as lists of sectors were submitted by participating governments and the GATT secretariat. This

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1 See, for example, papers by P. Burn, "Professional services and the Uruguay Round: Lessons from the Canada United States Free Trade Act Agreement", R. de C. Grey, "1992, Services and the Uruguay Round", and L. Abugattas, "Services as an element in economic cooperation among developing countries", in UNCTAD Trade in Services: Sectoral Issues, UNCTAD/ITP/26, 1990.

2 See "Services in the world economy", UNCTAD/TDR/8 Offprint, U.N. publication, Geneva, February 1988.

3 See GATT BISD, 33rd Supplement, pp. 19-30.

4 See GATT Newsletter "Focus", No. 61, May 1989.

process of examination has been the main activity of the Group of Negotiations on Services during 1989.

5. The following paragraphs draw upon current discussion on trade in services, in particular, the sectoral studies prepared in UNCTAD,[5] including at the national level in developing countries and by other international organizations,[6] with a view to identifying certain problems that will have to be taken into account in establishing multilateral disciplines aimed at liberalizing and expanding trade in services as a means to promoting the development of developing countries. The impact of technological advance is emphasized.

6. It should be emphasized that the problematics for trade in services are not exclusively problems of an economic nature. As will be noted below and as has been observed in previous texts, certain service sectors are the key to the achievement of national policy objectives in the areas of national and cultural sovreignty, national security and development objectives which transcend considerations of economic growth. In addition, efforts to liberalize trade in services confront the problems presented by the difficulties in applying traditional trade policy concepts and principles, which have evolved to govern trade in the goods sector, to services where questions of the cross-frontier movement of persons, capital and information are paramount.[7] In other words, efforts to liberalize trade in services will have to deal with basic asymmetries between the situation of countries and, in this case, essentially between developed and developing countries, to permit all countries to perceive that they have something to gain from the liberalization of trade in services. This will call for a multilateral framework which effectively deals with a multitude of economic, technological, cultural, legal and diplomatic problematics some of which have been briefly highlighted below.

A. Market Issues

1. Services in the economy and the impact of trade

7. TD/B/1197 discussed the contribution of services to resource allocation, utilization, mobilization and creation and the possible impact that liberalization of trade in services could have in this respect. The major impact on (a) employment and (b) balance of payments of certain service sectors, has traditionally influenced the attitudes of governments to trade in these services; recently, a third consideration has also become prominent, i.e. (c) the impact of services on the competitiveness of exports of goods and services in the world market.

2. Employment

8. As many studies have stressed[8] the service sector is the main source of new jobs in most countries, both developed and developing, and service specific policies are used as a tool for stimulating employment. For example, the construction sector is a major employer

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5 See Trade in Services: Sectoral Issues, *op.cit.*

6 See, for example, OECD, Trade in Services and Developing Countries, Paris 1989.

7 Rodney de C. Grey "Concepts of trade diplomacy and trade in services", Thames Essay, No. 56, Trade Policy Research Centre, Gower, London 1989.

8 UNCTAD/TDR/8 Offprint, *op. cit.*, Chapter I.

in most countries and devices to increase or decrease construction activity are used by many governments as mechanisms of macroeconomic management. Tourism is another sector where government support policies are often employment-motivated, particularly with the aim of stimulating employment in less advanced regions of the country. Employment considerations are also paramount in export processing zones. The essential question, however, is whether the employment impact of expanded trade in the sector - i.e. an increase in exports - would lead to a corresponding increase in employment or whether imports could displace domestic employment. This issue was addressed in the OTA study[9] which concluded that, in general, expanded exports of services as such would not result in major increases in employment in the United States. This conclusion, however, is based on assumptions about the modes of delivery used, i.e. that most trade would take place through commercial presence/establishment abroad which would stimulate employment in the importing rather than the exporting country. This, however, is clearly not the case in tourism, nor in construction whenever foreign non-local workers are employed. As was shown in the Trade and Development Report 1988, services exported through the movement of persons abroad, whether recorded as "other services" or as "labour remittances", are of crucial importance to a significant number of developing countries. In many cases, both the export and import of services can serve to upgrade the quality of employment in terms of the development of skills, to the extent that it brings developing-country service suppliers into contact with more advanced technologies, organizational skills and information.

3. Balance of payments

9. TDR88 also illustrated the impact of trade in services on the balance of payments of developing countries, with respect to which developing countries tended to fall into two broad categories: (a) those where exports of services, mainly in the form of tourism and skilled and semi-skilled workers providing services abroad, enabled them to finance deficits in trade in goods; or (b) those where surpluses in the export of goods, often primary commodities, were often overbalanced by deficits in trade in services even in situations where countries were attempting to run up large current-account surpluses to meet their international financial obligations.[10]

10. Developing country policies aimed at increasing the contribution of services to the balance of payments entail both export and import policies focused on specific service sectors. On the export side the promotion of tourism would seem to be the most widespread, although for some countries the encouragement of workers to provide services abroad - e.g. as construction workers, seamen, domestic help etc. - is a major policy objective. In both cases, employment considerations are also significant. On the import side, many countries maintain policies aimed at reducing foreign exchange costs of essential services such as shipping[11] and insurance, as well as of outgoing tourism.[12] On the other hand, countries appear prepared to omit payments with respect to airline services from balance of payments controls

11. Within certain services sectors, there can be different sub-sectoral impacts of liberalized trade. In insurance, for example, most countries discourage cross-border trade in

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9 US Congress, Office of Technology Assessment, "International Competition in Services", Washington D.C., 1987.

10 UNCTAD TDR 8 Offprint, *op. cit.*, Chapters II and V.

11 See P. Faust, "Shipping services" in UNCTAD Trade in Services: Sectoral Issues, *op. cit.*

12 The OECD identified three categories of balance of payments constraints (a) general, in the sense of GATT Article XVIII:B, (b) strains arising from the import of a particular services, and (c) short-term balance of payments strains arising from foreign exchange outflows from the import of a particular service, insurance, maritime transport and construction and engineering are deemed to be of greatest developing country concern in the second category, tourism, professional, information, communication and computer services in the third. See Trade in services and developing countries, OECD, Paris, 1989.

mass insurance such as life insurance, which is seen as a means of retaining savings for investment in the national economy. On the other hand, in the reinsurance area, trade proceeds much more freely as the capacities of individual countries to spread the coverage of large risks is limited.[13]

4. Services and competitiveness in goods

12. The third major imperative facing developing countries is to introduce new service inputs as a means of applying new technologies, more efficient forms of organization and effective quality control, to penetrate foreign markets for manufactures and agricultural processed products, including in their traditional productive specializations. In many instances, the absence of modern services is already depressing the export capacity of developing countries, and access to services for the purpose of supporting trade in goods has become a major necessity.

13. Unlike the situation of developed countries where the development of services in advanced economies has occurred over a long period of time, in symbiosis ("demand-led") with progress in industrial organization and production, which has given them a significant comparative advantage in terms of know-how and infrastructure; in developing countries the demand for services is latent and can only be extracted through "supply-inducing" strategies.[14] Three such strategies seem to be available: either to buy the necessary services from abroad, or to produce them domestically, or to encourage their local production through foreign direct investment (FDI).

14. The first option involves the short-term benefits of a quick access to both services and technology and hence rapid improvements in the competitiveness of existing production. It can also stimulate efficiency in key sectors whose linkages with other sectors could result in the elimination of "bottlenecks" and an overall improvement in the efficiency of other sectors. However, several potential drawbacks may be encountered (a) it increases the import dependence of the country, which may not be offset, in terms of trade balance, by the gains from improved exports, this tendency has been mentioned in TDR 88; (b) procured services may not be "appropriate" to the products and processes of the country in that other factors may undermine efficiency gains or create negative externalities, thereby having a lower impact than expected;[15] (c) the strategy could lead to the phenomenon of "captive producers" which could imply a worsening in the relative share of service value added and exacerbate the passive role of developing-country producers by undermining their capacity to respond to the exigencies of the world market;[16] (d) it could stifle the development of skills if highly skilled, knowledge-intensive service activities were carried out abroad.

15. Promoting domestic development in services, particularly for producer services, therefore, can been seen as not only a balance-of-payments measure on the export or import side, but as a means of increasing value added and the development of human capital and as an element in a strategy for upgrading the technological capacity of the whole economy. Advantages would be gained to the extent that such policies could result in (a) the supply of services more closely geared and fitted to the local needs and conditions; (b) the improvement in competitiveness in existing production together with an increase in the

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13 F. Outreville, "Trade in insurance services", in Trade in Services: Sectoral issues, *op. cit.*

14 See UNCTAD TDR 8 Offprint, *op. cit.*, especially Chapters I and III.

15 For example, the "efficiency" of transnational banks observed in their major operations in developed countries is not always reflected in the acctivities of their establishments in developing countries, see SELA "International Trade in Banking Services", Caracas, 1989.

16 See CEPAL, "Los Servicios al Productor en La Industria Latinamericana: Informe Consolidado de Cuatro Estudios de Caso", LC R.709, Santiago, 15 November 1988.

domestic share and control over the value added chain; (c) the development of infrastructure and human capital supportive of modern production, and processes more apt to spread over several sectors, and with the potential of stimulating further technological and organizational progress. On the other hand, this strategy involves a lengthy and difficult process. Resources may not be readily available (especially skills), slowing down gains in competitiveness. Moreover, the import content requirements - in terms of for example - technology, of domestic production, at least initially, could be very high. In any case, know-how in services and technology does not develop in a void and "infant industry" protection in the sense in which it has been used for goods, would not appear to be a viable strategy. What is rather required is the appropriate regulatory "interface" between foreign and domestic producers structured so as to strengthen the competitive position of the latter.

16. Production of services by a foreign service supplier in the domestic market can be a means of obtaining producer services without major domestic capital outlays and without, in principle, a worsening of import dependence. Such services are actually produced (at least partially) in the host country, thereby increasing its share of world service value added. Moreover, local people employed and trained by the foreign branch build up knowhow and skills which can lead to future spin-off effects. These benefits, however, are highly contingent upon whether such foreign presence is in the form of "free-standing" service branches, - i.e. establishments offering services on the open market - rather than "intra-corporate" services i.e., investments geared to supply services only to parent firms operations abroad. A major consideration is thus the externalization of intra-corporate knowhow, technology and service transfers. It would also be necessary to ensure that the greater competitive advantages of the foreign firms derived from knowhow and information accumulated at the parent company level does not stifle the development of a domestic supply, nor attract the scarce domestic human capital from domestic ventures. Foreign firms might also impose their own organizational and technical models, indirectly contributing to increases in technology imports, as foreign service firms have been shown to have a high propensity to import services.

17. Therefore, from the point of view of developing countries, progressive liberalization of their markets could be initiated with respect to those services where such liberalization would have a positive impact on the competitiveness of their exports of goods and other services. This would argue in favour of the liberalization of certain producer services, subject to the appropriate policy and regulatory framework to ensure that the liberalization had the desired positive effect.

18. The need mentioned above extends beyond the simple need for increased services inputs for production, maintenance and operation of manufactured goods. The ability to link up, to be able when needed to rely on specialized technology-supplying services firms, is becoming a essential for participation in international trade. The speed of delivery, ease of communication and, more generally, efficiency in the use of network services is becoming a major factor in terms of international competitiveness. Failure to be able to provide such efficiency and quality might mean exclusion from international markets. For developing countries it is essential to develop or, where necessary, to provide all the incentives for the emergence of such network and specialized technology supplier service firms,[17] or to participate in such networks on the most favourable terms possible.

19. On the other hand, care must be taken to avoid becoming captive producers or customers. The links to such a network, without some degree of control of the various services involved, could result in a continuous erosion of the value added from exports, as that obtained by the raw materials and labour input is continually reduced as compared to the service input. Lack of a service network relegates developing-country producers to a passive role where producers do not have any direct contact either with the upstream services

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[17] See Luc Soete and Marcela Miozza, "Trade and Development in Services, A Technological Perspective", *mimeo*, UNCTAD, forthcoming.

(i.e. design and conception of the product) or downstream services which bring the producer in direct contact with the market. Such considerations present a major qualification to efficiency-based arguments for the liberalization of trade or investment in producer services.

20. Captive production is particularly notorious in the area of primary commodity production where coffee and tea producers have been able to obtain a very limited percentage of the final price to the consumer in the importing country. The recent impressive expansion of exports of Chilean fruit has been at the expense of leaving over 90 per cent of the value added in the hands of (mainly foreign) service producers.[18] The phenomenon of captive consumers arises when increased service support to sales of goods renders it difficult for customers to change suppliers easily.[19]

21. Quite apart from the role of services as an input to the production and sale of goods, is that of the service sector as a market for goods, and the extent to which technological advance, domestic deregulation and the liberalization of trade in services can stimulate markets for goods and equipment. In the telecommunications and audiovisual sectors, for example, the market for the equipment ancilliary to providing the service is far greater than the value of the service itself. The proponents of the liberalization of the provision of telecommunication services have stressed that such liberalization would also involve for the provider of the "enhanced" services (who in this scenario would acquire the right to plug in to the national telecommunication network) the right to purchase telecommunication equipment from any supplier.[20] The Sony purchases of CBS and Columbia would seem to constitute a strategic response to a situation where markets for goods could not be assured without a greater degree of market control over the provision of services.

5. Market structure

22. Efforts to liberalize trade in services and to achieve an expansion of the trade of developing countries will have to take account of the peculiarities of market structure as between sectors. Developing countries as a whole, and most developing countries individually, run deficits in trade in services, the main exceptions being the travel sector and services rendered through the movement of labour abroad. The latter are often recorded as labour remittances rather than exports of "other" services. Only a few developing countries show surpluses in any other sector. In construction, for example, where a few developing countries have had a relative export success, this has been largely attributable to their ability to move personnel across national frontiers.[21]

23. The statisitics for measuring trade in services are extremely inadequate, as are those for estimating overall size of markets. The concepts of measuring trade, from the point of view of the actual market operators, may differ substantially from balance of payments statistics.[22] In financial services it is difficult to dissagregate clearly trade from capital flows i.e., to sort out financial flows *per se* (such as foreign exchange transactions which amount to several billion dollars per day, and interest payments) from payments for financial

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18 See CEPAL, "Las Servicios al Productor en la Fruticultura Chliena de exportacion", L/R/775, Santiago, 3 July 1989.

19 See UNCTAD/TDR/8/Offprint,*op.cit.*, Part II, page 179.

20 The negotiating mandate laid down in the United States Omnibus Trade and Competitiveness Act groups telecommunications services and equipment within a single negotiating objective.

21 See Y. Soubra, "Construction and engineering design services sector: Issues relevant to multilateral negotiations on trade in services", in Trade in Services: Sectoral Issues, *op. cit.*

22 Also, as noted in TDR 88, it may reflect the specific characteristics of fiscal regulations in individual countries as to whether it is more profitable to report earnings as stemming from "trade" or from investment abroad.

services rendered.[23] Professional services such as advertising and accounting are measured by total billings[24] (which include local billings by firms located abroad) and construction by the value of "contracts",[25] concepts broader than that of trade. The "travel" item in the balance-of-payments account underestimates the size of the "tourism" market, as it omits revenues obtained from the tourist before he leaves his own country and payments to foreign hotel chains and tour operators. Thus, developing countries are likely to have a much lower share of the overall "tourism" market than that indicated by the balance-of-payments data. The difficulties in measuring inter-firm transactions and the tendency of firms to offer a package of services further complicate efforts to estimate the overall size of service markets and identify the size and direction of trade flows.

24. Major efforts are being made to improve statistics on trade and production of services, at the national level as well as by the "Voorburg" group, organized informally under the auspices of UNSO. An important problem confronting negotiators relates not only to absence of sufficiently disaggregated trade statistics which identify the direction of trade flows, but also the essence of an internationally agreed "nomenclature" for services, the absence of which would seem to constitute a major impediment to the negotiation of commitments to liberalize services trade.[26]

25. Developing countries show a relatively low percentage of total service exports, when balance-of-payments data are used. If the broader concept of "trade" in services is adopted, including movemement of factors of production where this is essential to provide the service concerned, certain developing countries' "exports earnings" would be likely to show an increase, as more labour remittances would be included; but the share of most developing countries in world trade in services would be even less than that recorded in the IMF statistics, if income from branches of foreign corporations were considered as "trade". Apart from the need to clarify the statistical concepts, clearly, efforts to reach agreement on a multilateral framework to liberalize trade in services progressively would be difficult in the absence of a definition of "trade in services" if only to delineate the scope of concessions which could be requested and granted in future negotiations.

26. Developing country trade surpluses in services can be explained largely by the weak economic and financial position of developing countries e.g., most people from developing countries go abroad to work, not to consume. This weakness would also explain their small and diminishing participation in trade in financial services. In certain sectors, however, developing countries have presented the most dynamic import market (e.g., construction and engineering services) although this might reflect to a large extent the existence of almost prohibitive barriers in developed country markets. In insurance the very low "insurance density" in developing, as opposed to developed countries, indicates that developing countries constitute a large potential market, and that there may be a high degree of saturation in developed country markets[27] which may explain why access to certain developing country insurance markets has become a priority for certain developed country firms.[28] Cultural and geographical factors have an important effect in shaping markets in many service sectors, tourism being an obvious example. The dominance of the United States in audiovisual services can also be partially attributed to cultural peculiarities. The long-standing international regulatory system in sectors such as air transport, explains the rela-

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23 For example, in the United States, statistical improvements which led to the identification of fees earned by banks for letters of credit and banker's acceptances, led to a $ US 2 billion increase in services exports. See Coalition of Services Industries, "The Service Economy", Washington, D.C., October 1989; see also SELA "International Trade in Banking Services" in UNCTAD, Trade in Services: Sectoral Issues, *op. cit.*

24 See T. Noyelle, "Business services and the Uruguay Round negotiations on trade in services", in Trade in Services: Sectoral Issues, *op. cit.*

25 See Y. Soubra, *op. cit.*

26 Pursuant to the decision at the Uruguay Round Mid-Term Review, the GATT Secretariat has suggested a reference list, which is based on the Central Product Classification.

27 See Outreville, *op. cit.*

28 See, for example, Cho Yoon-Je "How the United States Broke into Korea's Insuramce Market?", in *World Economy*, December 1987, pp 483-496.

tively respectable share of developing countries. On the other hand, the structure of markets is also influenced by the existance of bilateral agreements, such as the practice of reciprocity in the banking sector.[29]

27. In the rapidly growing area of business services the concentration of supply in industrialized countries is mostly a consequence of the symbiotic character of services and production development. Industry is the market for services as services themselves are an outcome of the finer technical and social division of labour proper to advanced economies. Further developments in service production have also been spurred by information technology conceived in the R & D centres of advanced economies' manufacturing industry. Initially geared to the domestic market, producer service firms in these countries are concentrating and expanding their business across the borders, exploiting their knowhow and specialization economies, and serving their transnational clients on a worldwide basis.

28. In conclusion, any apparent developing country strengths in trade in services would seem to arise from (a) inadequate statistics; (b) an ability to move persons across borders; (c) international regulatory frameworks which allow them at least a minimum market share; (d) unique cultural and geographical factors; and more recently (e) an ability to link lower cost skills to information technology and telecommunication. In all sectors, even where developing countries may show strengths based on balance-of-payments figures,[30] developed country firms would seem dominant for reasons which will be discussed below. It is possible that liberalization of service trade regulations in developed countries, combined with provisions for the transfer of technology, access to networks and other supportive measures foreseen or implied in the Montreal text, could lead to a strengthening of service firms in developing countries and an expansion of their exports. However, few, if any, countries would be able to assess their potential in advance. Such a situation would seem to militate in favour of progressive liberalization by developing countries being initiated in those sectors or sub-sectors where such liberalization was most consistent with their development situation and where the intersectoral benefits of liberalization were most pronounced. Future negotiations could take account of individual developing countries' export performance in services, as a result of the application of the rules, principles and concessions covered by the multilateral framework.[31]

6. Comparative advantage

29. The benefits of liberalization would also be obtained through the ability of developing countries to increase their exports of services. The expectation that a general process of trade liberalization will provide benefits for all participants derives from the theory of comparative advantage.[32] In the case of services, comparative advantage may be derived from factors which are clearly not "natural", but are a result of the level and pattern of prior development, and whose relative endowment is a function of the amount of resources invested in R & D and education, of the existing industrial and technological development, as well as government regulations. Such actions include (a) the endowment in know-how and skills; (b) the amount of existing physical infrastructure, i.e. the stock of fixed capital, including high technology equipment; (c) information capital, i.e. the amount of elementary and processed information stocked and the effective ability to apply technological innovations. To these factor-related comparative advantages one must indeed add institutional

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29 See "Service Boeki Jiyuka No Tameni", Economic Planning Agency, Tokyo, October 1988.

30 See, in particular, UNCTAD TDR 8 Offprint, *op. cit.*

31 Grey, in "Concepts of Trade Diplomacy and Trade in Services", *op. cit.*, p.166, suggests that such an approach could be an alternative to special and differential treatment.

32 For important insights into the applicability of comparative advantage to trade in services, see J. Nusbaumer, *Services in the Global Market* (Boston Dordrecht Lancaster: Kluwer Academic Publishers, 1987), and J.B. Richardson, "Approach to services trade theory" in *The Emerging Service Economy* (Oxford: Pergamon Press, 1987).

ones, which introduce market power distortions: i.e. (d) the size of suppliers and the size of the market (i.e. economies of scale in production and the existence of a large domestic market on which to build up knowhow); (e) economies of specialization (related to scale economies), which through the accumulation of specific knowhow and contact information increase comparative advantages; (f) the role of state regulation in furthering or preventing such scale economies.[33] It is for these reasons that the conclusion can be drawn "that developed countries overall, are likely to be more competitive than developing countries in most services".[34] This situation could be corrected over time to the extent that developing countries are able to develop the factors mentioned above. However, it would also call for an increased ability for developing country firms to compete in the world market.

7. Competitiveness of service firms

30. The extent to which progressive liberalization of trade in services could be consistent with the objective of the development of developing countries and the expansion of their services exports is closely linked to the ability of enterprises in these countries also to build up competitive strength progressively. Major factors for building competitiveness in services in general seem to be: (i) financial capacity; (ii) the ability to make effective use of telecommunications and information technologies; (iii) accumulated knowledge and skills; (iv) established relationships between suppliers and buyers; (v) the ability to be present in a major market; (vi) ability to offer a package of services, (vii) domestic market size; and (viii) appropriate government incentives. The degree of importance of each factor may differ depending on the type of service concerned.

31. Obviously, the financial capacity of a firm is an important aspect, as continuous investment is required to maintain these factors. Financial resources are the key factor in competitiveness in the world market for a variety of service sectors. The more obvious are banking, securities trading and insurance where the weakening financial resources of developing country firms have resulted in a decline in their participation in world trade in these services. Air transport is another sector where financial resources are becoming crucial given the pressing need for airlines to modernize their fleets. The provision of enhanced information services can involve important expenditure on infrastructure, not to mention that necessary to develop or acquire the technological capacity. Even in construction and engineering consultancy services, where the competitive position of developing countries may be somewhat stronger, the superior financial resources, in the sense of the ability to finance a package of engineering services, construction and capital goods available to developed-country firms, enables them to dominate international markets, and such situations are obvious in most service sectors where developing country firms simply lack the financial strength to compete, particularly given that one of the main competitive factors is the ability to move upstream and downstream and to offer a package of services. Regardless of technical competence, firms cannot compete in world markets without adequate financial backing. Asymmetries in the distribution of financial resources thus constitute a major factor distorting the possibility of an international division of labour in the services sector based upon comparative advantage. This would imply that the ability of developing countries to compete in trade in services, and thus to benefit from progressive liberalization by their trading partners, will be related to broader solutions to their financial and debt problems.

32. As has been stressed in many studies, the ability to apply the latest telematic technologies is essential to competitiveness for firms wishing to compete in the world market for services. The production and delivery of services relies highly on information

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33 See F. Martinelli, "Problematics in Trade and Development of Services", Naples, *mimeo*, 1989.

34 OECD, Trade in Services and Developing Countries, *op.cit.*, page 7.

infrastructures owing to the intangible and information-intensive nature of services. For the six service sub-sectors which were examined in the Uruguay Round context pursuant to the Montreal Decision - namely, professional and financial services, transport, telecommunication services, tourism, consultancy and engineering design - access to telecommunications and the establishment of information networks has been crucial in their business. Moreover, well applied information technology tends to increase the knowledge, skills and value of individuals and makes data and expertise more widely available.[35]

33. Human resource management is probably one of the most essential factors for building competitiveness. This would be particularly crucial for professional services, owing to their knowledge-intensive nature,[36] for example, the large investment in human resources in the accounting industry, which ranges from about 15 to 25 per cent of gross revenues.[37] The key issue in human resources is that knowledge and skills are developed and accumulated over time: consequently, what the firm has been capable of doing in the past contributes to a great extent to the firm's current know-how and to its reputation, which are vital components in its competitive position.[38] This implies that newly established service firms would have a heavier pressure to build up their human resources, and investment required for acquiring knowledge and skills might be relatively higher than for established competitors, in addition to the difficulties in competing with firms with established international reputations.

34. Satisfied clients tend to stay with the same supplier as the intangible nature of services makes it difficult to determine the advantages of switching to alternative suppliers. Moreover, services firms in the areas of accounting, advertising and management consulting, handle much information which is of a confidential or strategic nature, thus, switching service providers or relying on too many suppliers increase the client's risks of doing business in a world where competitors, raiders or other potential adversaries are all seeking to obtain such information.[39] Such established relationships enable firms to follow the transnational corporations in their global operations.[40] Geographical and historical aspects would also help firms to establish relationships with clients, although the lack of these attributes might be offset by strategically managed business operation.[41]

35. Market presence is of particular importance for service firms which look for a niche market as they need to obtain precise information on potential customers, as well as on competitors. Having access to markets where firms could have complex assignments would be of particular importance for competitiveness building in knowledge-intensive services. Human skill development and product innovation in the firm occur in the environment where competition is intense and the demand is exigent. For example, with respect to computer software services, it has proved essential for developing country firms to have their staff present in the most sophisticated developed country markets, both to improve their competitive ability and to avoid being relegated to status of "subcontracters".[42]

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35 "Professional Services Firms and Information Technology: Ongoing Search for Sustained Competitive Advantage" from Managing Innovation: Cases from the Services Industries, p.183, National Academy of Engneering, Washington D.C., 1988.

36 See statement by the Chairman of the Morgan Stanley Group Inc., "Meeting Summary on Building a Competitive Service Company", p.3. A Meeting of International Associate Programme, 26 - 28 October 1988, New York.

37 See T. Noyelle, *op.cit.*

38 "Strategies in Global Competition", Neil Hood and Jan-Erik Vahlne, p.130, IIB, 1988.

39 T. Noyelle, *op.cit.*

40 The Japanese advertising firm which has the largest strength in the domestic market is seeking expansion in Europe and the United States through acquistion. The prime motive of this move is to follow Japanese clients which are expanding their business in these two regions. "Japan's Dentsu Inc. Weighs Purchase in Europe or U.S.", The Wall Street Journal (Europe), 31 October, 1989.

41 "Trade and Development Report 88: Part II", p.157 Also, see C. Fontaine's " L'expansion des services: Un quart de siecle en france et dans le monde developpe, Tome III (L'offre des services), REXERVICES, Paris, 1987.

42 See S. Srivastava, "Computer Software and Data Processing Export Potential" in *Services and Development Potential: The Indian Context* , UNCTAD ITP 22.

36. The ability to provide a range of services gives a competitive edge to a firm as it means convenience, greater choice and cost saving to the customers. This is apparent in a variety of service sectors, banking,[43] tourism, media, the combinations of cleaning/security/building maintenance, audit/management consultancy, software/system analysis, distribution/finance. Diversifiction of services requires human and financial resources, as well as advanced information technology and consequently this trend is more prominent in large firms; the logical strategy of small service firms may be specialization rather than diversification.

37. Such competitive positions can be strengthened through mergers and acquisitions. For example in accounting, advertising, legal and consultancy, market concentration through such means seems to be the far most significant trend which is structuring the international market in these services and creating the situation of concentration of ownership described below.[44] Also, the global networks which multinational firms in these services have established in the past years has enforced the market domination by these firms. The importance of geographical networks would increase in the future as the international division of labour in both manufacturing and services sectors progress, and consequently, small-and-medium-sized firms will increasingly become involved in international business.[45] In air transport services where access to markets is subject to bilateral negotiations and mergers often prohibited by law, competition is achieved through networking and through competition in ancilliary services, including competition among computerized reservation systems (CRS), which automate many travel agency functions and reduce the agencies unit costs for booking reservations and issuing tickets.

38. Having a large domestic market protected by regulations or other factors, appears to be a significant advantage in the service industries whose prime target is a "mass" rather than a particular segment of the market. The audio-visual and transport industries are a prominent example. For these industries the size of the market, which implies the potential profitability, is a very important factor as their production/operation costs are high. It also enables a cross subsidization from domestic to foreign operations.[46] Control of distribution channels is also a key to competitiveness in certain service industries as discussed below.

39. The past experience in both developed and developing countries suggests that certain protection and incentives provided either directly or indirectly by the State were necessary to develop or to sustain the competitiveness of certain services. Government procurement policies for some domestic services - e.g. airlines and shipping, advertising, construction and engineering, telecommunications and informatic services - are a classic example. Also, consulting, construction and engineering firms from developed countries serving in developing countries are frequently associated with tied aid projects. Data flow policies have helped to distribute computers, software, data bases and skilled human resources throughout the country.[47] Developing countries' firms can gradually build up more competitive export capacities in the context of liberalization among developing countries, including at a regional and sub-regional level.[48]

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43 See SELA "International Trade in Banking Services", *op. cit.*

44 See, for example, TD B RBP 61.

45 In developing countries the big six accounting firms would seem to dominate business with transnational and major local companies while "all the rest" would deal with smaller local firms. See J. Friedland, "A call to account", Far Eastern Economic Review, Hong Kong, 9 November 1989.

46 See S. Christopherson and S. Ball, "Media Services: Considerations relevant to multilateral trade negotiations", in UNCTAD, Trade in Services: Sectoral Issues, *op. cit.*

47 "Role of the Developing Countries in the Services Sector" in the Meeting Summary of Building a Competitive Service Company. *op.cit.*

48 See L. Abugattas, *op.cit.*

8. Concentration of ownership

40. In attempting to build up a competitive position, developing country firms are faced with the phenomenon of the concentration of ownership in many service sectors. In virtually all service sectors, developed-country firms would seem to be dominant. The extent to which market power is concentrated in a limited number of firms, or in a limited number of countries, varies from sector to sector, but is increasing in virtually all and, in some, has reached dramatic proportions. An extreme concentration of ownership is witnessed in the accounting sector where the world market is dominated by the now "Big Six" accounting firms,[49] and in the reinsurance sector where, for example, four firms from three countries account for over 30 per cent of the world reinsurance market.[50]

41. In other sectors the level of concentration would seem to be high and growing rapidly particularly in advertising (dominated by a group of United States, British and Japanese firms), audiovisual services (dominated by the Motion Picture Association of America cartel). This concentration also applies to tourism (hotel chains and tour operators). In these sectors, the world market is dominated by a reduced number of firms from a small number of home or "exporting" countries. The country concentration is quite dramatic in sectors as diverse as hotel operations and data processing,[51] where United States' firms account for 8 and 9 respectively of the top ten firms in the world. In the banking sector, international operations are being increasingly dominated by the 300 largest banks, of which over half are from four countries.[52] There is also the phenomenon of "horizontal concentration" where service firms are broadening the scope of their operations to acquire dominant positions in interlinked sectors, often those where the same telematic and human resources can be used.

42. Accounting and advertising firms are diversifying into consulting services, and the competition in consultancy services among these firms is growing. In the United States a large number of leading management consultancy firms have major accounting firms or advertising agencies as their parent.[53] In air transport where mergers and foreign acquisitions are often prohibited, airlines are linking up to share routes and ancilliary services, including air cargo.[54]

43. Ownership patterns can change as a function of other interrelated technological and regulatory changes. Often regulations have prevented ownership and activities across service sectors (e.g. film producers from cinemas, banks from insurance and securities trading). Such regulatory divisions appear to be breaking down due to technological advances which are eroding barriers between industries and to the importance of networks and distribution channels in domestic and international competition, although technological advances may in turn be creating pressures for new divisions.

44. Concentration of ownership may not in itself always imply restrictive practices or a diminishing of competition. For example, despite the importance of a handful of large firms in the advertising sector, advertising fees have been steadily declining in a relative sense.[55] However, concentration can imply barriers to market entry for newer, smaller

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49 See T. Noyelle, *op.cit.*

50 See J. Outreville "Trade in Insurance Services" in "Multilateral negotiations and Service Sectors", UNCTAD, *op.cit.*

51 See IDATE, "Les Services de la Communication dans le Monde", 1989, Bureaux de Polygone, Montpellier, France.

52 I.e., Japan, the United States, Federal Republic of Germany and France.

53 T. Noyelle, *op. cit.*

54 The Wall Street Journal (Europe), 19 october 1989, "JAL, Lufthansa and Air France could link global air freight operations, report says", and Nippon Keizai Shinbun, 18 october 1989.

55 T. Noyelle, *op. cit.*

firms, and a tendency to a geographical concentration of services resulting from the tendency of producer services to locate near the headquarters of large firms where strategic functions are concentrated.[56]

45. Thus, while concentration of ownership cannot necessarily be equated with uncompetitive practices, it is a factor to be taken into account in efforts to liberalize trade in services. First, political reality is such that no government could accept to see those service sectors deemed to be essential to its ability to manage the economy, or protect national security and sovreignty, including cultural sovreignty, fall under foreign domination. In this respect, developing countries whose firms may be particularly vulnerable would be required to exert particular vigilance. Secondly, it would seem both inequitable and a waste of resources to undertake major international negotiations to liberalize trade in service sectors, where such liberalization would only serve to strengthen the position of already dominant firms from a limited number of countries and to increase the rent such firms are already gaining from trade in the sector concerned. If negotiations are launched in such sectors they should logically be aimed at reducing such concentration to enable developing country firms to compete effectively in world markets, or ensuring that the behaviour of dominant firms behaviour complies with the development objectives set in Punta del Este and Montreal.

9. Strategic importance of particular sectors

46. In TD/B/1197 the "strategic" importance of certain sectors from the point of view of their contribution to the attainment of national policy objectives was mentioned. TDR88 noted that this concept of the strategic role of services could be extended to include not only national sovereignty, security, basic infrastructure for the needs of the population and the functioning of the economy, but also the development of human capital and the upgrading of employment opportunities, the competitiveness of national firms in the world market, the location of production and decision-making functions.

47. The strategic importance of transportation in communications sectors is quite obvious. However, one can also identify certain sectors or subsectors whose role is strategic in that, despite the relatively small value of the transactions involved, they affect decisions which govern the direction of trade in other sectors. An example is the engineering, consultancy and design sub-sector, which although much smaller than the construction sector in terms of value of trade, operates so as to determine, to a large extent, the sources of the supplier construction projects.[57] A different example is the audiovisual sector where the value of "trade" is surprisingly low,[58] although its impact on the overall society - not only from a cultural point of view, but also economic - as a means of affecting tastes and purchasing habits, not only through its interlinkages with the advertising sector but also by adding to the prestige of the exporting country internationally, extends far beyond the value of trade in the sector itself. In referring to the "strategic" aspects of service sectors, one is in fact stressing the extent that control considerations may be relatively more important than efficiency considerations.

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56 J. Howells, "Technological Innovation, industrial organization and location of services in the European Community", FAST Occasional Paper 142, Commission of the European Communities, Brussels, April 1987.

57 Y. Soubra, *op. cit.*

58 See OECD, International Trade in Services: Audiovisual Works, Paris, 1986.

10. Interlinkages with other sectors

48. The interlinkages among services sectors and the blurring of the frontiers between sectors are becoming more pronounced. Telecommunication, for example, is not only a service in itself, but a medium for the trade in other services, a problem arises in defining the borderline between a telecommunication service *per se*, and a financial or audiovisual service transmitted through telecommunications facilities. Audiovisual services transmitted through the telecommunications infrastructure can, in turn, transmit advertising services which, in turn, can be a means of promoting other services such as tourism. Such interlinkages, and the fact that they are being continually altered through technological advances, obviously provide difficulties in the drawing up of appropriate regulations aimed at accomplishing a particular national objective in a specific sector.

49. Increased interlinkages among services sectors and between service sectors and the manufacturing sector imply that the intersectoral costs of protection may be high. On the other hand, they also increase the strategic role of certain services in the economy and the importance of national control in achieving national policy objectives.

50. On the other hand, in some services the distinctiveness of the sector is largely a result of regulations and not *vice versa*. Legislation such as the Glass Steagall Act of the United States restricts the types of service activities in which firms can participate and thus creates separate "sectors" whose activities are quite similar and require a similar knowledge and skill base. For this reason, information technology which has eroded the barriers between service sectors in general, and intensified competition at the international level has created pressures for the removal of these intersectoral regulatory barriers. On the other hand, the possibility of the application of information technology for anti-competitive purposes has led to presures for new regulatory divisions.[59] As noted below, such regulated delineations pose problems for those seeking to liberalize trade in services, particularly given the importance of reciprocity considerations (either formal or informal) in trade negotiations.[60]

B. Legal and institutional issues

1. Regulatory framework

51. Since the beginning of the international debate on a possible multilateral framework for trade in services, attention has been drawn to the fact that service activities are more highly regulated than the production of goods, and for different reasons, peculiar to the special characteristics of services.[61] In the Uruguay Round context, it has been recognized that progressive liberalization should aim at reducing the "adverse effects" of laws, regulations and administrative practices. Different types of regulations exist for different purposes, posing different sets of problems for efforts to liberalize trade.

52. Efforts to liberalize trade in services progressively will have to address not only the pervasiveness of regulations in services, as a whole, and the differences in the extent and nature of regulations in different countries, but also the fact that, at the multilateral level, some services are subject to a carefully articulated structure of agreements and others to none at all. For example, in civil aviation and telecommunications, a set of multilaterally

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59 E.g., to preclude airline ownership of computer reservation systems.

60 See Rodney de C. Grey, "1992, Services and the Uruguay Round" in Trade in Services: Sectoral Issues, *op. cit.*

61 See, for example, TD B 1008 Rev.1, Chapter IV.

agreed regulations exist administered by ICAO/IATA and the ITU respectively. These bodies have long been in existence, have virtually universal membership and have their own mechanisms for the adaptation of their regulations which involve setting standards to meet new situations. Trade in the services concerned has evolved within the particular structures of these multilateral frameworks. A multilateral regulatory instrument exists also in the shipping sector in the form of the United Nations Code of Conduct for Liner Conferences, an instrument which does not have universal membership and applies only to a relatively small segment of world shipping, that controlled by conferences. This segment, however, is of particular interest to a large number of developing countries, and the Code was drawn up with primarily development interests in mind. Trade in services is also affected by a variety of international conventions and agreements such as INTELSAT, the Florence Convention, the Basle Committee on Banking Regulations and Supervisory Practices etc.

53. Some of these multilateral frameworks channel competition into certain areas. For example, in the air transport sector, competition within the bilateral framework takes the form of the reduction of ancillary costs, quality of service, provision of ancillary services (especially computer reservation systems) and through negotiating network arrangements with other airlines. The protective aspect of the bilateral system, however, can provide certain firms with lucrative protected domestic markets which facilitate their ability to compete internationally. The international bodies administering these frameworks also play a standards setting role which would seem to facilitate market competition and reduce the possibility of captive markets being established by "locking-in" client to supplier standards.

54. Frameworks for the liberalization of trade in services exist in OECD instruments, notably the Code on the Liberalization of Current Invisible Operations, the Code on the Liberalization of Capital Movements and the Decision on National Treatment. Under these instruments a considerable degree of liberalization of trade and investment in services has been achieved among OECD Member States. All OECD countries have accepted the legitimacy of the principles and goals set in these instruments, while maintaining a range of measures inconsistent with these principles and objectives by invoking reservations. Liberalization is achieved through gradual disinvocation of the reservations through a process which has been described as "peer pressure". Reservations once removed cannot be reinvoked and there is a continuous process of seeking to tighten obligations. The GATT concepts of reciprocity, mutual balance of rights and obligations and retaliation are largely foreign to OECD. The fact that many members of the OECD are also member States of the EEC and are moving towards the same goals within set time limits (supplemented by the free movement of labour) as a matter of contractual obligation, has obviously facilitated the process.

55. Regional integration schemes among developing countries are also intensifying their efforts to more effectively incorporate services. In some cases, it has been recognized that the neglect of services in the past appears to have constituted a significant impediment to progress in the integration process.[62]

56. The regulation of service sectors is much more prevalent at the national level. Such regulation can apply to the quality of the service, the activity of providing the service, and/or the service provider, whether a physical or moral person (i.e. an enterprise). Such regulations can be imposed by governments including, federal, provincial, State or local governments, as well as self-regulation by non-governmental bodies such as professional associations whose authority in this respect is recognized by governments at different levels. Earlier in the debate on services the idea of "liberalization" was often associated with that of "deregulation". Detailed analysis of the specific service sectors has shown that this is not gererally the case and that in certain sectors, liberalization, in the sense of allowing improved competitive opportunites for foreign suppliers of services could actually lead to

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62 See L. Abugattas in Trade in Services: Sectoral Issues, *op. cit.*

increased regulation. Much depends upon the purpose of the regulation. Greater foreign participation in certain areas of the financial service sector has been shown to lead to a need for more stringent prudential regulation.[63] In general the proponents of progressive liberalization of trade in services have stressed that their aim is to remove those aspects of the regulations which discriminate against foreign suppliers, either formally or *de facto* i.e., their "adverse effects" and not to achieve deregulation *per se*.

57. The effect of regulations on trade in services and the problems facing the progressive liberalization of such trade are in many cases a function of what is being regulated, i.e. the service itself, the provider, or the cross-border movement of the provider. Trade in professional services, for example, is affected by regulations which affect the legal ability of the supplier to provide the service - e.g. licencing requirements in the medical, legal, accountancy professions.[64] Even if persons in these categories are allowed to enter the country, they are unable legally to exercise their professions. In other services in this category, where licencing is generally not required, such as computer software services, professionals face trade barriers in the form of frontier measures, in that they are either not allowed entry, or refused work permits.[65] It is felt that developing countries may be discriminated against in both instances, first in that their professionals may have more difficulty in obtaining recognition of their licences in developed countries and, second, that work visa regulations may favour the nationals of other developed countries. Trade liberalization will thus have to concentrate on freer access to work permits where movement of persons is essential to delivering the service and on defining non-discriminatory mechanisms for the mutual acceptance of qualifications. The Canada/United States Free Trade Agreement contains innovative mechanisms in this respect, some of which might be applicable at the multilateral level.[66]

58. Certain aspects of the regulation of services are inherent to the situation of the developing countries as has been pointed out in TD/B/1197. Their balance-of-payments difficulties are the motive for regulations which affect trade in financial services in particular, but also in tourism, transportation and other sectors. The fragility and vulnerability of their economies, their enterprises and often their cultures are the justification for regulations whose purpose is precisely to provide protection for domestic producers in many sectors, against perceived threats of domination by foreign corporations. However, in many cases, the motivation is not to shield local producers (which may often be the State) from foreign competition *per se* , but rather to restrict the macroeconomic, strategic or cultural impact of the activities of foreign suppliers.

59. The effects of technological advances and changing institutional structures often require an almost continuous process of adaptation of regulations. This has been observed, for example, in the sectors of telecommunication and financial services and for the regulation of new services such as the computer reservation systems, referred to above, for which new regulations have recently been adopted by the European Community.[67] The fact that audiovisual services can now be transmitted through satellite and cable telecommunications networks has also called for regulatory reform in many countries.[68] Many developing countries find that their regulatory structure is inadequate for the purpose of strengthening certain service sectors and upgrading human skills, and therefore such considerations will dictate an increase in regulations in the future. Their concerns not to be

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63 OECD, Trade in services and developing countries, *op. cit.*, page 14.

64 In certain cases, this relates to ability to provide skills of a universal character e.g., medical, in others local knowledge is obviously essential e.g., law.

65 Noyelle, *op. cit.*

66 P. Burn, *op cit.*

67 Council Regulation (EEC) No. 2299 89 of 24 July 1989, on a code of conduct for computerising reservation systems, also comments in Grey, "1992", *op. cit.*

68 See OECD, International Trade in Services: Audiovisual Works, Paris 1986.

impeded in this process have led to the recognition of their right to introduce new regulations in the Uruguay Round context.[69]

60. Regulations introduced so as to enforce standards have a special significance in services. Such standards can be of a prudential nature (e.g., insurance), relate to professional qualifications (e.g. professional services), to cultural content and levels (e.g. audiovisual, advertising), or technical levels and compatability (e.g. telecommunications, civil aviation, eletronic data interchange) etc. Efforts to liberalize trade in services progressively while promoting the development of developing countries and respecting national policy objectives will have to address the standard issue and the possible desirability for international harmonization in certain cases.

61. The activities of specialized international organizations with respect to standards would appear to have an impact on developing countries' ability to expand their service exports and undertake commitments to liberalize services trade. In the area of technical standards, international harmonization has had a major impact on telecommunications and transport. EDIFACT (Electronic Data Interchange for Administration, Commerce and Transport), IFTM (International Forwarding and Transport Message) and numerous technical annexes to the Chicago Convention on Civil Aviation are a few examples. However, the rapid and uneven development of technology in different countries creates pressures for the undermining of international standards where they exist, and thus the dangers of an exacerbation of technological asymmetries and an intensification of barriers to market entry and creation of captive markets. In contrast, standards related to professional qualifications complicated by cultural, linguistic, religious and socio-political considerations, have generally not been dealt with at the multilateral level (in some cases not even at the national level). Efforts at international harmonization with respect to professional qualifications would also appear to constitute an important aspect of the progressive liberalization of trade in services.

2. Barriers to trade in services

62. Liberalization, will thus focus on the adverse trade effects of laws, regulations and administrative practices. As has been noted in previous documentation, the penetration of international markets for services involves the cross border movement of at least one of, or a combination of, the following: (a) persons, (b) capital, (c) goods or (d) information. Regulatory and other barriers to the movement of such "modes" can inhibit trade in services and attempts to develop typologies for barriers to trade in services have inevitably involved categories based on the aspect of regulations which restricted the access of the final customer to these "modes". The liberalization of trade in services gives rise to a different set of problems depending upon the mode of delivery primarily used in the sector concerned, both from the point of view of the impact on the regulatory system of the importing country and on its economic and social policy objectives.[70]

63. The economic and social policy aspect has been discussed in earlier documentation.[71] However, important legal and institutional issues are also involved. The liberalization of trade in services may call for separate legal mechanisms for dealing with each mode of delivery, including movement of factors of production. The movement of persons across borders to supply services would require the innovative mechanism of link-

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69 See Uruguay Round Mid-Term Review, Part II, *op. cit.*, paragraph 7(h).

70 In the Uruguay Round it has been recognized that cross border movement of factors of production may fall within the definition of "trade" in services when it is "essential" to the supply of a service and when the following occur: (a) cross border movement of service and payment, (b) specificity of purpose, (c) discreteness of transactions, and (d) limited duration.

71 UNCTAD/TDR/8 Offprint, Chapter III, *op.cit.*

ing immigration regulations to trade agreement obligations. For example, persons meeting criteria set by the trade agreement and subject to multilateral enforcement, could be given special legal status, both with respect to immigration - e.g., visas or work permits - and/or with respect to licences of professional qualifications which, in many countries, are controlled by provincial or State governments or private associations. This would permit such persons to practice their trade or profession in other countries within the sectors or sub-sectors so defined. Such agreements could also contain mechanisms aimed at the mutual recognition of qualifications. Some of these issues have been dealt with in the Canada/United States Free Trade Agreement which is instructive in this regard.[72]

64. The movement of capital would appear to give rise to legal issues not completely analogous to the movement of persons. As noted above, in the Uruguay Round context it has been recognized fact that some movement of the capital factor (i.e. commercial presence) may be essential to the supply of the services. This gives rise to two questions: (a) the technical question of "essentiality" and (b) the legal question of the negotiation of "rights" of establishment, or "commercial presence".

65. The question of when presence in the market is essential for the provision of a service mirrors the discussion of barriers to trade and modes of delivery below, i.e. whether restriction of a mode of delivery effectively impedes the ability of a services supplier to provide a service. The intent of the qualifications in paragraph 4 of the Montreal text appears to be to ensure that a concession with respect to access to market is effectively confined to the sector or sub-sector for which the concession was granted, and to establish the frontier between trade, which would be covered by the framework, and immigration and investment which would not.[73] The idea of "commercial presence" embodies the concept of that amount of cross border movement of capital necessary effectively to supply the service to foreign customers. This concept has been defined in the context of the Canada/United States Free Trade Agreement in the specific context of enhanced or computer services.[74] It would seem that this concept of "commercial presence" would differ considerably as between sectors.

66. No "right" of establishment has ever been accepted multilaterally. For example, the Havana Charter stated that a country has the right "to determine whether and to what extent and upon what terms it will allow future foreign investment"; an agreed paragraph of the draft United Nations Code of Conduct on Transnational Corporations confirms that "States have the right to regulate the entry and establishment of transnational corporations including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors".[75] However, countries have exchanged concessions relating to establishment in bilateral treaties, although any right of establishment is usually highly qualified.[76] Another problem relates to the origin of the firms that would obtain such commercial presence.

67. One problem in including capital movement in a multilateral framework of reciprocal rights and obligations, is that it could imply that governments would have a right to intervene through bilateral, diplomatic channels or in multilateral forums, such as a possible

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72 See P. Burn Trade in Services: Sectoral Issues, *op. cit.*

73 Fatourous points out that in the context of EEC law, "limited duration" is the principal element that distinguishes "establishment" from the "provision of services", see A.A. Fatourous, "Key Concepts in International Investment Arrangements and their Relevance to International Transactions in Services", paper presented to UNCTC Workshop on the Activities of Transnational Corporations in Services, Montreux, 11-12 November 1989.

74 "The establishment of offices, ... appontment of agents and installation of customer-premises equipment or terminal equipment ... for the purpose of distributing, marketing, delivery of facilitating the provision of an enhanced or computer service", see P. Burn, *ibid.*

75 See Fatourous, *op.cit.*

76 Grey points out the differences in approach between the situation in the United States, where foreigners are assumed to have a right to establish unless (as is the case in several sectors including certain service sectors) specifically excluded by law, and that in most other countries, where it is assumed that the government retains an unlimited right to impose limits or prohibitions on establishment - unless such rights have specifically been conceded by treaty, R. de C. Grey, "Concepts of Trade Diplomacy and Trade in Services" *op. cit.*, p.128.

dispute settlement mechanism under the multilateral framework, to further the interests of firms which they consider "theirs", operating in foreign countries.[77] The question of which "person" on behalf of whom a State is entitled to propound an international claim has been addressed by the International Court of Justice.[78] The position of the capital-importing States has been reflected in such principles as the Calvo Doctrine,[79] which have maintained that if foreigners were to be admitted to local commerce on an equal basis, they should resolve their problems within the domestic legal system of the host country and should not be granted the advantage of appealing to their home governments, or suing the host country outside its national territory.

68. Such problems might be overcome by clearly designating those firms which would be considered as "foreign" in the sense that actions which nullified their ability to benefit from the agreement could lead to a foreign government initiating dispute settlement action. Currently there is a wide variation in the criteria used by governments to determine whether a firm is national or foreign.[80] This aspect would appear to be related to the national treatment issues as it could also give rise to the question as to whether foreign-owned firms could be considered "national" for the purposes of domestic, including fiscal law, while still continuing to enjoy "rights" under the multilateral agreement in virtue of the obligations or concessions in favour of their home country. As has been pointed out in several studies, the application of the national treatment principle in negotiations on services will require a greater measure of agreement as to the acceptable limit of the assertion of jurisdiction extraterritorially.[81] In certain cases, establishment is imposed by governments of the importing country to ensure that the operations of foreign firms are made effectively subject to national laws and regulations. Prudential considerations, such as in the insurance sector, are often a major motive. In such cases, foreign firms might be seeking a "right" to non-establishment. It has been suggested that concessions in this respect could be extended if the home country committed itself to ensure that the prudential standards were met.

69. It is clear that the elements of a definition of trade in services, as laid out in paragraph 4 of the Montreal text, would seem to be much more easily applied to some sectors than others; those to which such criteria would most easily apply would seem to give rise to relatively less legal complications of the class mentioned above. However, such difficulties would inevitably have to be confronted in establishing what would be in effect a multilateral agreement for the treatment of the movement of persons (either individual or "corporate") and the conduct of their economic activities.

70. The importance of information as a key factor in the international competitivenesss of firms has been discussed in considrable detail in previous documentation.[82] Information flows through the telecommunications network or, more accurately, through the interconnection of national networks, by which services are jointly provided by the national operators in two countries and which thus would not appear to constitute "trade" under the criteria developed to date.

71. Liberalization of the movement of information as a means of delivering a particular service would have to be distinguished from the liberalization of telecommunication services *per se* - i.e. the ability of foreign firms to provide telecommunication services to customers in foreign countries.[83] In other words, information transmitted through the

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77 Grey, "Concepts of trade diplomacy and trade in services", *op. cit.*

78 See J.G. Starke, Introduction to International Law, Ninth Edition: London, Butterworth, 1984, pp. 304-309, 335.

79 Lipson, Standing Guard, *op. cit.*

80 See O.G. Whickard, "International Transactions in Services: Conceptual and Definitional Issues", paper presented to UNCTC Seminar on "The Activities of Transnational Corporations in Services", Montreux, 11-12 November 1989.

81 Grey, "Concepts of Trade Diplomacy and Trade in Services", *op.cit.*, p. 157.

82 UNCTAD/TDR 8 Offprint, *op. cit.*

83 R. Pipe, "Telecommunications services, considerations for developing countries in Uruguay Round negotiations" in UNCTAD, Trade in Services: Sectoral Issues, *op. cit.*

telecommunication network as a means of enabling service firms (e.g. tourism or financial services) to deliver their services effectively to foreign clients is related to access to markets for suppliers of the service concerned, with respect to which telecommunications is a mode of delivery. As such information movement would be conceivably an element of a market access concession, it does not give rise to the same set of issues of national sovreignty etc., as those involved in liberalizing access to foreign markets for foreign telecommunications suppliers to provide their services directly to domestic customers. As has been pointed out in many studies, this distinction between telecommunications and information services has become "blurred",[84] and a further blurring arises when the "enhanced" services themselves are devised for the needs of a particular services sector. In any case, efforts to expand trade in services through liberalization of the "information mode" would involve a different set of considerations than for the liberalization of access to markets for telecommunications services *per se*.

72. In addition, information flows can be viewed as a competitive factor in which access to strategic information from abroad can provide firms with absolute advantages, providing them with a competitive edge over local firms despite advances in "know how " by the latter ("information" and "know-how" are not the same thing). This brings up the question as to which information should be considered as private or confidential, subject to proprietary rights, as exclusive cross-border transfer and use of proprietary know-how and firm-specific services, including through private infrastructures, would not be available as an "externality" to other local users. This is also relevant to the question of access to information networks, as discussed below. Information flows, like movements of persons and capital, also give rise to certain politically-sensitive issues, such as the storage of data in foreign data bases.[85]

73. The importance of modes of delivery as a factor in enabling countries to realize their full competitive potential in international trade in services is implicitly recognized in paragraph 7(g) of the text of the Uruguay Round Mid-Term Review, which provides that foreign services may be supplied according to the "prefered mode of delivery" (where market access has been made available and subject to the definition of trade in services and other provisions of the multilateral framework). As has been recognized by the OECD secretariat, "the realization of developing countries' export potential in services will depend, in large measure, on the scope for acknowledgement within a services framework of the need for services provider mobility in the form of temporary relocation of essential personnel".[86] As has been noted in other papers,[87] this consideration is also important to professional service firms in both developed and developing countries.

3. Access to information networks and distribution channels

74. The importance of the access to information networks and distribution channels as a means of enabling developing countries to expand their service exports has been recognized in the Uruguay Round.[88] The significance of information networks and distribution channels for the maintenance of a competitive postion in international trade in services is dramatically apparent in many service sectors. In the tourist sector, for example, traditionally considered as being a sector of "interest" to developing countries primarily owing to the fact that balance-of-payment figures show developing countries running large sur-

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84 R. Pipe, *op. cit.*, also stresses attention to the need to draw distinctions between (a) facilities, (b) equipment, (c) services and (d) information in any attempt to address trade problems in the telecommunications sector.

85 See UNCTAD/TDR/8 Offprint, Chapter III, *op.cit.* and OECD *"Trade in Services and Developing Countries"*, *op.cit.*, p.12.

86 "Trade in Services and Developing Countries", OECD, Paris, 1989, p.8.

87 T. Noyelle, *op. cit.*

88 Mid-Term Meeting, Part II, paragraph 7(g), *op.cit.*

pluses in tourism, world-wide tourist revenues are dominated by developed-country firms which have been able to establish such networks, i.e. hotel chains, travel agencies and computer reservation systems (CRS). The CRS are a striking example of the importance of information networks.[89] Even the largest and airlines are finding it necessary to link up to maximize the profitability of information networks (i.e. computer reservation systems which themselves have become a major source of profits) and the distrbution channels, i.e. routes.[90]

75. On the other hand, the concept of access to networks and distribution channels is somewhat different in the telecommunication sector where it is seen as the right to "plug in" to the national network so as to be able to provide so-called "enhanced" or "value-added" services directly to customers in the importing country. This has given rise to a set of problems related to national sovreignty, standards, and related issues of access to markets for goods and equipment,[91] as well as the basic definitional problem of differentiating, as noted above, between the use of the telecommunications network to export telecommunications services *per se*, and its role as a mode of delivery for other services.

76. However, the concept of information networks extends beyond these more obvious examples. Certain authors have referred to a "networked economy" in which information networks are vital to maintaining a competitive position and creating value in virtually all service sectors, and constitute the main link between services and the attainment of competitiveness and value creation in the manufacturing sector. A "network" has been defined as "a set of technical means, or infrastructures and strategic norms - enabling actors with rights of access to set up and manage value creating relationships among themselves".[92] These authors consider that "every network can be seen as a specific set of interactions among a number of actors who collaborate in extracting value from their relationships" and that "networks must provide for a physical capacity to interact. They must, therefore, have access to proprietory or shared infrastructure through which interactions can be channelled".[93]

77. Networks can be classified into the the four categories of "intracorporate","transcorporate", "intercorporate" and "metacorporate" networks. The purpose of intracorporate networks being that of co-ordinating day-to-day activities by enabling end-users within the same company to share information and processing capacities, while that of transcorporate network takes the form of links between a firm and its closest suppliers and partners. Intercorporate networks implement corporate alliances enabling corporations to share strategic information, technological know-how, cooperate in joint ventures etc. The fourth category, metacorporate networks, aims at affecting the environment in which a group of firms operate, particularly with respect to setting and implementing common information technology standards.[94] Thus, the concept of access to information networks involves much more than just "plugging in" and is closely linked to access to, and transfer of, technology.[95] It would appear that for developing country firms to be able to translate such "access to information networks" into expanded service exports, they must become full participants in the intercorporate and transcorporate networks described above.

78. The role of distribution channels extends beyond the marketing of goods or services and, when linked with information networks, is but a means of establishing closer relations

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89 See A. Bressand and K. Nicolaides ed., "Strategic Trends in Services, A Services World Forum Project", New York, Harper and Row, 1989.

90 A. Bressand, "Access to Networks and Services Trade" in Trade in Services: Sectoral Issues, *op.cit.*

91 Pipe, *op. cit.*

92 A. Bressand, F. Distler and K. Nicolaidis in "Networks at the Heart of the Service Economy" in A. Bressand and K. Nicolaides ed., "Strategic Trends in Services", *op. cit.*, p. 25.

93 *Ibid.*

94 Bressand, Distler and Nicolaidis, *op. cit.*, pp.26-30.

95 See G. Spriano, "R & D Networks: The Energy Market for Technological and Scientific Services", in Bressand and Nicolaidis, *op. cit.*

with clients so as to enhance competitiveness and increase value added, and possibly leading to captive markets, as has been discussed in a number of studies.[96] Upstream in the production chain, control of distribution channels and "onstream" services can create "captive producers". The net result of captive producers and captive markets is maximum value added for the service suppliers.[97] The combining of information networks and distribution channels has created the feedback mechanism (e.g. market intelligence, inventory management) whose competitive impact was stressed in TDR 88. In fact, much of the FDI in services in developing countries over recent years has been aimed at establishing distribution channels.[98]

79. The phenomenon of information network/distribution channels as a key to competitiveness and value added in trade in services would seem to have peculiar characteristics in certain sectors. In air transport, for example, the distribution channels can be expanded only through difficult bilateral negotiations, profitability is derived from the linking and sharing of such existing distribution channels and information networks.[99] In media services, the control of distribution channels permits the producer to control the timing of the presentation of films - a vital component of the value of the production - as well as to ensure a market for its products and its technology.[100] The recent trend toward multimedia or media service/media product corporations has been illustrated most dramatically by the Time/Warner merger and the purchase of the United States firm Columbia Pictures by Sony of Japan.

4. Restrictive and unfair practices

80. In certain sectors, notably audiovisual, restrictive business practices such as cartels would seem to be a major factor in world trade.[101] Although, in general, limited information exists on RBPs in the service sector, action has been taken by a variety of developed-country governments to deal with RBPs in sectors such as insurance, banking, air transport, advertising etc., and this would appear to be occurring in other sectors as well.[102] The changing nature of the corporate structures resulting from technological advance and regulatory changes may result in corporate behaviour which, on the one hand, could result in RBPs assuming forms that are more difficult to both define and detect, and, on the other, a series of corporate practices not RBPs, in the legal sense, but which could result in negative effects on development programmes and call for consequent new forms of regulation at the national and international levels.

81. The recent concern with anti-competitive practices in computer-reservation systems illustrates (a) how services traded through information networks can lend themselves to such anti-competitive behaviour, and (b) the difficulties in attempting to impose traditional concepts of competition law on such trade, given, for example, that the notion of RBPs implies the existence of an intent to distort the rules of normal competition. There is perhaps a need to redefine what constitutes "normal competition" in a world where a firm's competitive position derives from its networking ability. Efforts will have to be made by governments, particularly those of developing countries, to ensure that such practices do not serve to nullify the beneficial results of the progressive liberalization of services trade, by undermining the expected efficiency gains or creating barriers to market entry to

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96 See Martinelli, *op. cit.*, and Soete and Miozza, *op. cit.*

97 See CEPAL, L.R 775, *op. cit.*

98 UNCTC, Foreign Direct Investment and Transnational Corporations in services (United Nations Publication, Sales No. E.89.II.A.1.).

99 See A. Bressand, Trade in Services: Sectoral Issues, *op.cit.*

100 Christopherson and Ball, *op. cit.*

101 Christopherson and Ball, *op. cit.*

102 The Wall Street Journal (Europe), "Travel Marketing by a British Firm Raises Canadian Row", 22 November 1989.

developing-country firms. In any case, any efforts to liberalize trade in services progressively will have to address the competition law aspect.

82. Among the set of what have been traditionally considered as "unfair trade practices" there could be a tendency toward predatory dumping. This can arise, as in goods, from the practice of firms to use high profits in a protected domestic market (arising from trade restrictions or other e.g., cultural factors) to cross-subsidize penetration of the world market.[103] Also, overall packages of services, particularly where tied aid is involved, could encourage the dumping of strategic services (i.e., engineering services) where, for example, feasibility studies provided virtually free of cost when linked to large projects which include finance and capital goods, thus eroding the position of equally skilled national firms.[104]

83. Certain countries have begun to introduce unfair competition legislation to deal with unfair trade practices in trade in services comparable to anti-dumping and countervailing duty legislation on goods trade. One example is the European Community in the area of shipping.[105] It seems inevitable that governments will seek to arm themselves with mechanisms to protect the interests of national service suppliers against actions comparable to predatory dumping in the goods sector. It is also clear that this could provide a potential mechanism for the harassment of legitimate trade as has been done with respect to trade in goods - perhaps even more so, given the difficulty in identifying such concepts as "fair market price" in a sector where quality considerations, "networking" and "packages" are prevalent, and where it is often virtually impossible to calculate a unit price and statistics are generally inadequate.[106]

84. It has been observed that, in general, firms investing abroad may wish to centralize a number of key operations to reduce their vulnerability to expropriation and other policy actions of the host government.[107] However, it appears that in many service sectors, notably professional services,[108] there is a geographical decentralization of skills within corporate structures and a built-in necessity on the part of the foreign corporations to invest heavily in the training of local personnel - particularly in developing countries - who often subsequently become employed by domestic firms.[109] Other studies foresee a new international division of labour in services production in which centralized decision-making headquarters co-ordinate widespread and distant operations, many of which are only "delivery" branches, which may be the case in at least certain service sectors, such as audio-visual and certain engineering services.[110] Therefore, a distinction must be drawn between the development of human skills and access to the information necessary to take strategic decisions. The extent to which branches of foreign service corporations operating in developing countries possess this capacity would seem a matter for further study, and probably differs considerably from sector to sector.

85. The centralization of the decision-making function was probably less of an impediment to development in the past, when the main interest of the host country was to exploit its natural resources and to provide employment opportunities. Since, in the future, the

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103 See S. Christopherson and S. Ball, *op. cit.*

104 See Y. Soubra, *op. cit.*

105 See J.-F. Bellis, E. Vermulls and Ph. Musgrave, "The New EC Regulation on Unfair Pricing Practices in Maritime Transport: A Forerunner of the Extension of Unfair Trade Concepts to Services?", Journal of World Trade, Geneva, February 1989.

106 See Grey, "Concepts of Trade Diplomacy and Services", *op.cit.*, where it is argued that the introduction of "anti-dumping and countervailing duty" type approaches would inevitably lead to increased restrictions on trade in services and constitute a "retrograde" step, and that a preferred approach would be for governments to undertake greater commitments to dissuade their firms from RBPs, dumping and other unfair practices abroad. Given the extent to which services are already regulated, such an approach would seem more feasible for services than for goods.

107 See Charles Lipson, Standing Guard, University of California Press, London, 1985, p.23.

108 Noyelle, *op.cit.*

109 Particularly in the insurance and professional service sectors, see Noyelle, *op. cit.*, p.10.

110 See Martinelli, Moulaert and Djellar, The Role of Information Technology Consultancy in the Transfer of Information Technology to Production and Service Organizations, Report to the Nederlandse Organisatie voor Technologisch Aspectenonderzoek, The Hague 1989, as well as Christopherson and Ball and Soubra *op.cit*

benefits of foreign-direct investment in the service sector will be seen in terms of transfer of technology and access to information, corporate strategies which serve to frustrate these objectives could well be viewed, if not as RBPs at least as deviating from "good citizenship" behaviour. Information technology is often regarded as a powerful enabling factor for a greater diffusion of information as a truly "free good", thereby enhancing competition among firms. The free circulation of information is nevertheless restrained by a number of factors: (a) the need for specific capital equipment to read, store, process and transmit digital information; (b) the actual access to information, which is most often protected by a number of proprietary devices. Rather than promoting competition, these constraints can constitute significant barriers to entry. Information technology can permit both extensive decentralization or centralization - it is a matter of corporate strategy and policy framework, although the operation of certain service industries has shown to be incompatible with centralized operations.

86. Considerations with respect to concentration of ownership and corporate behaviour (whether or not RBPs are involved) would seem to illustrate the necessity of obtaining more details regarding the operations of service transnationals as an element of the application of the principle of transparency, recognized as an essential component of the liberalization of trade in services.

5. Barriers to entry

87. The difficulties faced by developing-country firms in acquiring the competitive factors mentioned above, the concentration of ownership and the problem of access to, and participation in, information networks and distribution channels, can create significant barriers to market entry. Such barriers are exacerbated, however, by strategies adopted by corporations and governments to render market access for new entrants more difficult.

88. There is a school of thought which considers that contemporary economics is characterized by competition for "economic space" between nation States and TNCs, and that the growing globalization of corporate activities, greatly reinforced by contemporary progress in information technology, is altering the degree of control and the effectiveness of Governments' capacities to effectively implement national development objectives. Within this "space", transnational corporations compete against each other less in the sense of price competition than in the establishment of "networks", "captive producers" and "captive markets" with the objective of maximizing value rather than rationalizing costs,[111] and through strategies aimed at raising market entry barriers to new entrants. Such barriers to entry, including in the form of scale economies, are having an increasingly important impact on new entrants.[112] The phenomenon of the proliferation of small and medium size firms in the 1970s appears to be increasingly undermined by growing capital requirements and the need for complex interdisciplinary work in R and D (although these can be countered by public R & D networks such as ESPRIT)[113] as well as established organizational and marketing structures to exploit products commercially. Moreover, the rapid pace of technological change requires quick capital amortization and, hence, the need to prevent the emergence of new entrants, in order to prolong the life cycle of products and reap the corresponding returns for as long as possible.

89. Barriers to entry, however, are also enhanced by government action, particularly when related to access to new technologies. While promoting deregulation and liberalization in many areas, developed-country governments have adopted measures as to promote and protect domestic development in information technology and related services in

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111 See L. Edvinsson, John Richardson, "Service and Thoughtware" in Bressand *et. al., op.cit.*

112 Martinelli and Schoenberger, 1990.

113 See G. Spiriano, *op. cit.*

developed market economies.[114] There has been a growing perception that the concerns of nation States coincide with those of their leading technology corporations (seen as "national champions") and that their international expansion merits government support.[115] However, the opportunities offered by scale and scope economies in strengthening market power at the international level can sometimes have the effect of frustrating developing countries' national concerns, in that internalized flows of goods, services and information within corporate structures further decrease the capacity of host countries to control their own development. As part of their competitive strategy, corporations try to keep knowledge and information as captive as possible i.e., within national or corporate boundaries, with the aim to both internalize benefits (further accumulation of know-how and information) and to limit opportunities by other firms to enter their market.[116] The enforcement of intellectual property rights and the extent to which they can be extended to cover a wide range of diverse knowledge and information can aggravate barriers to entry for developing country firms. However, there is an inherent contradiction between the need to sell technology and services and the goal of maintaining proprietary control over technology and know-how. Knowledge and information are less easy to protect and control than other factors of production, and opportunities exist for developing countries to appropriate and further develop some of these in the course of trade relations.

6. Supplier rights and obligations

90. As noted above, it has been accepted in the Uruguay Round that trade in services as defined in an eventual multilateral framework could involve cross-border movement of factors of production where such movement is essential to suppliers. This reflects the concern of many countries that they would not benefit from any framework which was confined to transactions between residents and non-residents and that some "presence" or "establishment" in the foreign market would be required either by firms or individuals. Such factor movements have been qualified by the provision that it should involve (a) cross-border movement of service and payment, (b) specificity of purpose, (c) discreteness of transactions, and (d) limited duration.

91. This approach has given rise to the greatest difficulty in applying trade policy principles developed for goods in the GATT context to trade in services. Trade policy principles which apply to goods - whose origin can be determined, whose ownership normally changes in the process of international trade, whose entry can be measured and controlled - give rise to serious incongruencies when attempts are made to apply them to physical or moral persons.[117] Much debate has already taken place on these issues, which has highlighted such differences as (a) the difficulties in determining which measures could constitute permissible and thus negotiable protection, and which measures would be *a priori* prohibited, given that it is difficult to envisage a single mechanism for trade in services corresponding to the tariff for trade in goods.[118] and (b) the different implications of the application of the national treatment principle to goods, from its application to services, which in effect means to persons or to firms.[119] In fact, the rights and obligations which are

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[114] C. Vaitsos, "Radical technological change and the new "order" in the world economy" in *Technology, trade policy and the Uruguay round*, UNCTAD ITP 23, forthcoming 1990; G. Dosi, Technological Change and Industrial Transformation, McMillan, London, 1984.

[115] See UNCTAD "Revitalizing Development Growth in International Trade: Report to UNCTAD VII", UN Publication Sales No. E.87.II.D.7, also S. Rossen, "Notes on rules and mechanisms governing inter-related economic relations", Berger, Ch. Michelsen Institute, 1981.

[116] Martinelli, *op.cit.*

[117] GATT, Uruguay Round Mid-Term Review, Part II, paragraph 4, *op. cit.*

[118] See Grey, "Concepts of Trade Diplomacy", *op. cit.*, p. 47.

[119] "...in regard to trade in services, a general provision for national treatment ... will inevitably lack precision and may be only normative, what could provide precision are provisions for national treatment in specific agreements on service industries, *Ibid.*, p.47..

being proposed extend beyond GATT to those developed in the context of investment and transfer of technology.

92. If the multilateral framework for trade in services is to be based upon a set of mutual rights and obligations, such rights and obligations will have to address (a) the rights of governments with respect to the treatment of their "persons",[120] with respect to their entry into foreign countries and their operation in foreign territory; (b) the obligations of such foreign governments with respect to the activities of such "persons"; (c) the obligations of these "persons" with respect to the government of the territories in which they are allowed to enter and to conduct business. One particular aspect is the subject of considerable attention in the current efforts to liberalize international trade in services, i.e. the obligations that could be accepted by foreign enterprises to ensure the compatibility between "progressive liberalization" of trade in services and the development of developing countries and expansion of their service exports, as foreseen in the Punte del Este Declaration and the Uruguay Round Mid-Term Review.

93. If persons, whether moral or physical, are somehow to be given "rights" under a multilateral agreement (e.g. the right to national treatment) then, in the view of some participants in the negotiations, it would seem logical that these "persons", and not only foreign governments, should be called upon to accept a set of obligations aimed at maximizing their support to the national policy objectives of the host country and, in particular, the development policy objectives of the developing countries. Transfer of technology has been identified as a major contribution which, in some cases, appears to flow as a matter of course from the activities of certain foreign firms, in the area of professional services for example. It has been suggested that such obligations could take the form of obliging foreign firms benefiting from access to the market to provide education facilities directly or subject them to a tax intended for this purpose, and to make use of local service inputs where possible. There is also the separate but related question of access to, and participation in, information networks and distribution channels which has been discussed above. The importance of the appropriate regulatory framework or guidelines for maximizing the transfer of technology of firms benefiting from access to the domestic market, for achieving access to their information systems, and for ensuring the economic gains of liberalization have been discussed above. Such frameworks would seem essential to the maximization of benefits to developing countries from liberalization of trade in services.[121] This cannot avoid reference to issues being dealt with in the ongoing negotiations within the United Nations system on the codes of conduct on the transfer of technology and on transnational corporations.

94. In this context, negotiated "rights" to national treatment could be met by compensating obligations where the operations of service firms in the national market were governed by regulations motivated by social concern which could oblige firms to undertake non-profitable activities. This would be necessary to ensure that foreign firms also accepted comparable social obligations and did not confine their presence to high-profit "cream skimming" activities.

95. Transparency would seem an essential obligation in this respect. As noted above, estimates of trade in services derived from balance-of-payments statistics are inadequate to provide policy makers with a view of the world market and of the size and direction of trade. As there is no way of collecting such information at the frontier comparable to trade statistics on goods, the information must be obtained directly from the market operators themselves.[122] A greater degree of transparency with respect to these operations, which could be obtained through a concerted and cooperative effort by all governments, could, in itself, reduce one of the major causes of the reluctance of countries to accept contractual

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120 "Persons" in the legal sense, physical or "moral" (i.e., corporations).

121 OECD, "Trade in Services and Developing Countries", *op. cit.*

122 As seen in the sectoral papers included in Trade in Services: Sectoral Issues , *op.cit.* most of the information on market structure and trade is obtained from non-governmental sources.

obligations with respect to the liberalization of trade in services. This would be particularly true for developing countries, where greater transparency with respect to the operations of foreign service suppliers, both in their countries and in the world market in general, could assist in identifying ways in which such suppliers could more effectively contribute to their development objectives.

7. Reciprocity

96. While economists tend to scorn arguments in favour of trade reciprocity, it is a clear political reality that governments accepting commitments to provide market access to foreign service suppliers will have to demonstrate that they have received some form of reciprocal benefit from the other negotiating partners that will effectively permit them to expand their service exports. The application of multilateral reciprocity negotiated in multilateral negotiations and extended to all GATT Contracting Parties under the unconditional most-favoured-nation clause, has been central to the success of trade liberalization in goods under GATT. Unfortunately (as has been pointed out in earlier UNCTAD documentation with respect to the international trading system),[123] there has been a tendency toward the resurrection of concepts of bilateral reciprocity, such as the idea of "equivalent" access, where reciprocity is seen as a condition of access in one country being mirrored in another.

97. In trade in services, difficulties will be encountered in applying multilateral reciprocity owing to the impossibility, for example, of applying a mechanism affecting all service sectors, such as an across-the-board tariff reduction. The need to address the different modes of delivery will also constitute a complicating factor, although it is clear that in order to expand their exports developing countries will require greater access for their nationals to provide services abroad and access to information networks and distribution systems. The factors impeding the ability of developing country firms to compete in world markets which have been highlighted in the preceding paragraphs will also make it difficult to provide developing countries with effective reciprocity for any liberalization they might grant, unless specific compensatory measures are also provided.

8. Non-discrimination

98. Much has been written with respect to the key role played by the unconditional most-favoured-nation clause in the process of trade liberalization in goods carried out over 40 years in GATT and the negative implications of policies which undermine this principle (e.g. by including a conditional aspect) for the future of the trading system. Suffice it to say that strains on the unconditional clause appeared when serious attempts were made to deal with non-tariff barriers. These strains were less apparent where the price mechanism and generally applicable criteria could be applied, (e.g. anti-dumping duties) than where actual concessions were exchanged with respect to non-tariff barriers (e.g. Government Procurement Code). Some authors have chosen to address what they consider to be a conflict between unconditional most-favoured-nation treatment and reciprocity. In reality, however, the conflict would seem to be more between broad, multilateral reciprocity, and narrowly conceived sectoral or bilateral reciprocity. As many scholars have noted, historically, countries have tended to shift their advocacy from the former to the latter as their competitive position in international trade diminished.

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123 E.g. TD/274, TD/328 Rev. 1.

99. It would not seem that there are any inherent difficulties in applying the unconditional most-favoured-nation clause, as a general principle, to trade in services if countries are willing to accept the broad multilateral concept of reciprocity, under which countries agreeing to provide market access in sectors or sub-sectors where they did not possess a meaningful export capacity would be given compensatory concessions with respect to sectors of export interest to them. In this context, any *ab initio* limitation of the sectoral coverage of the multilateral framework could not help having a discriminatory effect and would detract from the overall objective of a broad multilateral framework. In sectors[124] where it might be deemed necessary to limit the number of foreign firms operating in the market, concessions could take the form of open quota systems, while specific concessions could be negotiated in the context of existing structures. Means of ensuring that arrangements for the mutual recognition of qualifications did not involve elements of discrimination unjustified on technical grounds would also be vital to the maintenance of this principle.

100. It is clear that countries would not wish the multilateral framework to inhibit their possibilites to liberalize trade in services within the context of regional integration schemes, or interregional preferential arrangements, among developing countries.[125] The key role of services in achieving such integration and the negative effects of not having addressed services issues in earlier agreements is increasingly recognized. Liberalization of services within such regional and preferential frameworks could assist developing-country firms to build up their competitive strengths and thus facilitate efforts to eventual liberalization at the multilateral level. Possible questions that could arise relate to whether such liberaliztion would be carried out in the context of arrangements on goods (e.g. those already covered by Article XXIV of GATT and the "Enabling Clause") or whether separate service integration arrangements could be contemplated.

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124 For example, insurance, see Outreville, *op. cit.*

125 See L. Abugattas, *op. cit.*

Chapter II

SUMMARY AND CONCLUSIONS

101. The following conclusions are put forward on the basis of the consideration of the issues dealt with in chapter I above:

(1) The liberalization of service imports can have a dynamic effect on the development process in developing countries, through the stimulation of efficiency in key sectors, access to technology and support to exports, if carried out selectively and within the appropriate regulatory framework.

(2) In such liberalization, care should be taken to ensure that imports of services do not undermine the ability of developing-country Governments to carry out strategic national objectives, including national security and cultural sovreignty, nor result in the stifling of the development of higher skills, knowledge-based services and information resources; access to services needed to ensure their ability to compete in foreign markets should not result in developing country producers or consumers becoming "captive" to foreign service suppliers, nor result in exacerbating existing balance-of-payments disequilibria.

(3) Firms from developed market-economy countries are dominant in virtually all main traded services sectors. Their competitive strength is based upon the underlying comparative advantages inherent in developed economies, as well as specific factors at the microeconomic level. Such factors include (a) financial capacity, (b) access to and domination of telecommunications and information technologies, (c) established relationships and market presence, (d) ability to offer a package of services, (e) domestic market size, (f) economies of scale, and (g) government incentives. If liberalization of trade in services is to benefit developing countries, their firms will have to acquire such capacities, which may only be possible in the context of solutions to more general problems of debt and infrastructural development. It will also have to provide for access to foreign markets for their professional, skilled and unskilled labour.

(4) There is a notable and growing concentration of ownership and market power in many service sectors, which, although it cannot be necessarily assumed will result in reduced competition, can create barriers to entry for newcomers, particularly for firms of developing countries, and promote a geographical concentration of service production. Barriers to trade can also be created by government and corporate measures restricting access to information and technology.

(5) Certain sectors have a particular strategic character in that they can affect the direction of trade in other services and in goods; in such sectors control considerations might tend to outweigh efficiency considerations.

(6) There is a need for a greater degree of transparency on the part of both Governments with respect to laws, regulations and administrative practices and on the part of corporations trading in services. Greater transparency by the latter is essential both to obtain a clearer idea of the market structure in the various service sectors and to ensure that their activities are consistent with the objectives of greater efficiency and the development of developing countries and expansion of their service exports. Such transparency will also contribute to improved statistics on trade in services, facilitating decisions by Governments with respect to liberalization.

(7) Some services are already the subject of longstanding multilateral regulatory frameworks at the international level; most are highly regulated at the national level, including through private associations, and at the provincial and State levels. Liberalization will have to address the adverse effects of regulation and not aim at deregulation *per se*. The acceptance of commitments with respect to the liberalization of the movement of factors of production within the definition of trade in services, as envisaged in the Uruguay Round, will call for the resolution of yet unresolved legal issues with respect to the treatment of foreign "persons". It will give rise to, *inter alia*, consideration of the obligations to be accepted by such "persons".

(8) In this context, the application of trade policy concepts to trade in services will require extreme care. In some cases, such application could result in an introduction of new discriminatory and restrictive measures or an unnecessary undermining of the unconditional most-favoured-nation principle. Difficulties will be encountered in providing effective reciprocity to developing countries whose firms rarely have the capacity of translating liberalization in developed countries into expanded service exports. Compensatory actions at the national and international level to assist developing country firms to increase their competitive positions are required.

(9) Liberalization within the context of integration schemes among developing countries can, in addition to furthering the overall integration process, provide an opportunity for developing country firms to strengthen their competitive positions and reinforce the eventual ability of developing countries to accept broader commitments to liberalize trade in services within the multilateral framework.

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OTHER ISSUES FOR CONSIDERATION BY THE BOARD AS MANDATED IN GENERAL ASSEMBLY RESOLUTION 1995 (XIX), AND IN THE CONTEXT OF THE RELEVANT PROVISIONS OF THE FINAL ACT ON INTERNATIONAL TRADE, AS WELL AS OTHER PERTINENT RESOLUTIONS OF THE GENERAL ASSEMBLY AND THE CONFERENCE

(b) THE IMPLICATIONS OF BILATERAL ARRANGEMENTS AND REGIONAL ECONOMIC INTEGRATION, ESPECIALLY THOSE WHICH HAVE A MAJOR IMPACT ON GLOBAL TRADE, IN PARTICULAR ON THE TRADE AND DEVELOPMENT OF DEVELOPING COUNTRIES

Report by the UNCTAD secretariat

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CONTENTS

Chapter		Paragraphs
	Introduction	1 - 6
I.	Overview of recent trends in economic integration arrangements	7 - 16
	A. General observations	7 - 9
	B. Integration experiences of EFTA, CMEA and developing countries	10 - 16
II.	EEC 1992 Programme and the Canada-United States Free Trade Agreement: market access issues	17 - 63
	A. Introduction	17 - 18
	B. The EEC 1992 Programme, access to markets and developing countries	19 - 47
	C. The Canada-United States Free Trade Agreement (FTA)	48 - 63
III.	Systemic implications of regional integration	64 - 74
	A. Introduction	64
	B. Article XXIV of the GATT	65 - 68
	C. Regional arrangements	69 - 74
IV.	Summary and some policy issues	75 - 88

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INTRODUCTION

1. This report has been prepared in response to the request in decision 367 (XXXV), paragraph 6, of the Trade and Development Board and represents the first effort to analyse some of the implications of "bilateral arrangements and regional economic integration, especially those which have major impact on global trade, in particular on the trade and development of developing countries" (decision 367 (XXXV), para. 6). The subject is so vast that it is not easy to cover all aspects in a short paper. The following anaylsis is a preliminary attempt to initiate the consideration of this subject.

2. The recent past has witnessed a resurgence of interest in the arrangements designed to integrate national economies in formal groupings revolving around customs unions, common markets and free-trade areas. The implications of these arrangements for both the developed and the developing countries are important for two reasons: first, they influence the pattern of growth of international trade and specialization and pose a variety of policy choices for third parties, - i.e. non-participants - in the arrangements. Obviously, the larger the volume of trade covered under such arrangements, the greater is likely to be their weight and influence in international trade. Secondly, regional and subregional groupings have a discriminatory effect inasmuch as they grant preferential market access to partners in the arrangements. The creation of trade groupings and similar arrangements - either bilaterally or in a plurilateral context - increase the potential for trade disputes, raise trade tensions, and generate concern about the future of the multilateral trading system.

3. While the analysis in this report reviews the recent trends in the integration arrangements in developed market economies, the Council for Mutual Economic Assistance (CMEA), and some intra-developing country groupings, it focuses in particular on the implications for developing countries of the European Economic Community's (EEC) 1992 Programme and the recently established Canada-United States Free Trade Agreement (FTA). To be sure, other trade arrangements and groupings, such as the European Free Trade Association (EFTA) and CMEA, 1/ as well as a number of bilateral/plurilateral arrangements involving developing countries also have an impact on international trade and the trading system. However, the weight of the EEC and the Canada-United States Agreement on international trade is of such a magnitude that developments in their trade policies significantly affect the trade of third parties.

4. The enlarged EEC - consisting of a grouping embracing 12 economies with a combined population of over 320 million and a combined GDP accounting for over 27 per cent of global GDP - represents the largest trading region in the world. Aside from its weight in the world economy, the Community has spawned a complex and extensive network of preferential arrangements covering a large number of GATT members. Thus, changes in EEC policies directly or indirectly affect both MFN access to its market and this network of preferential arrangements .

5. Unlike the EEC, the United States-Canada agreement is a free trade area, whereby the external tariffs of each party with non-members are not affected. However, for reasons similar to the EEC's, namely its weight in international

trade and the possibility of trade diversion, the Canada-United States Agreement will affect access to this market for non-parties to the arrangement. In addition, the Canada-United States FTA has given rise to an extensive review by other trading countries, particularly in the Pacific Rim, of the possible costs and benefits to them of the FTA and of joining in a FTA with the United States (or others). These developments raise the question whether, as a result of greater resort to bilateral or plurilateral arrangements, the international trading system is in the process of breaking up into two or three major trading blocs.

6. Chapter I reviews the recent trends in the integration arrangements among the major developed market economies, CMEA and a selected number of intra-developing country groupings. Chapter II focuses on the implications, from the standpoint of market access, of the EEC's 1992 Programme and of the Canada-United States FTA. Chapter III discusses the systemic consequences of the major regional integration schemes. Finally, chapter IV summarizes the salient points of the report and outlines some policy issues.

Chapter I

OVERVIEW OF RECENT TRENDS IN ECONOMIC INTEGRATION ARRANGEMENTS

A. General observations

7. The experience and performance of a select number of integration groupings during the 1970s and the 1980s are presented in tables 1 and 2. As is evident from table 1, experience with the growth in intra-trade - a useful measure of trade expansion among members of the grouping - differs markedly between the periods 1970-1980 and 1980-1988 and, in the latter period, between developed and developing country groupings. The decade of the 1970s was characterized by double-digit growth in intra-groupings trade - a phenomenon reflecting relatively buoyant trading conditions but also a relatively low volume of initial trade among developing-country groupings. The high growth experience is replicated in all groupings: among the highest intra-trade growth was recorded in several intra-developing country groupings, with Latin American Integration Association (ALADI), Andean Pact, Association of South-East Asian Nations (ASEAN) and Caribbean Community (CARICOM) recording intra-trade growth of 20 per cent or more per annum - i.e. the same as in the EEC. Trade among EFTA and CMEA countries also registered exceptionally high growth rates.

8. This trend was dramatically reversed in the 1980s: by 1988, growth in intra-trade in each of the groupings had declined markedly. In each of the intra-developing country groupings, growth in this trade had turned negative, with the largest declines recorded in the Central American Common Market (CACM), CARICOM and the Andean Pact. The apparent rise in the share of intra-trade in a number of economic groupings involving developing countries (and in CMEA) is a reflection of even faster declines in total trade, a phenomenon now extensively documented and reflecting the deterioration in trading conditions and access to external markets during the first half of the 1980s.

9. During the 1970s, in all the groupings (except the EEC) the rate of growth of total exports and imports tended to surpass that of intra-grouping trade, suggesting continuing improvements in access to and reliance on external markets. In the EEC, the rate of growth of intra-trade (for the enlarged EEC) was of the same order as that of total external trade, providing, in a tentative manner, an indication of the relative importance of intra-trade to total trade. This relationship assumes particular importance during the 1980s when intra-EEC trade grew faster than total trade - accounting, by 1988, for just over 60 per cent of the latter (table 2). The disquiet expressed in many quarters about the EEC's becoming more inward-looking stems from the observation of this trend, which indicates increased reliance on intra-trade and a tendency to shift adjustment problems to non-member trading partners. 2/ A similar trend is also evident in the bilateral trade between Canada and the United States: the proportion of this trade in overall trade rose from 26 per cent in 1980 to 34 per cent in 1988. The coming into force of the Canada-United States Free Trade Agreement (FTA) in early 1989 is likely to reinforce this trend.

Table 1

TRADE OF SELECTED INTEGRATION GROUPINGS:
AVERAGE ANNUAL GROWTH RATE
(per cent)

	INTRA-TRADE		TOTAL EXPORTS		TOTAL IMPORTS	
	1970-1980	1980-1988	1970-1980	1980-1988	1970-1980	1980-1988
EEC (12)	20.0	7.5	19.4	5.6	20.0	4.3
EFTA	16.6	4.5	18.9	6.0	18.4	4.8
UNITED STATES-CANADA	14.5	8.8	17.0	5.4	19.5	7.6
CMEA	15.6	6.1	17.6	4.6	17.7	4.1
ASEAN	24.4	-1.1 a/	27.8	-1.3 a/	23.7	6.1
ALADI	24.0	-3.2	20.3	1.7	21.8	-2.5
ANDEAN PACT	28.8	-4.7	19.9	-5.5	21.7	-0.3
CACM	14.8	-14.6 b/	15.9	-5.7 b/	17.1	-2.5
CARICOM	20.9	-7.4 b/	25.4	-10.8 b/	22.1	-8.9
ECOWAS	11.3	6.7 b/	27.1	-14.1 b/	24.2	8.4

Source: UNCTAD secretariat calculations.

a/ Refers to 1980-1987.

b/ Refers to 1980-1986.

Table 2

INTRA-TRADE OF SELECTED INTEGRATION GROUPINGS AS A PERCENTAGE OF TOTAL EXPORTS AND SHARE OF TRADE AND OUTPUT IN TOTAL WORLD EXPORTS AND OUTPUT IN 1986
(per cent)

	1970	1980	1988	Share of Global Exports	Share of Global GDP c/
EEC (12)	49.7	52.3	60.5	36.8	26.6
EFTA	19.4	15.9	14.2	6.6	3.9
CANADA-UNITED STATES	32.7	26.3	34.1	19.7	34.9
CMEA	59.3	50.3	56.6	8.0	
ASEAN	21.3	16.3	16.4 a/	3.3	1.5
ALADI	10.0	13.6	9.1	2.3	5.0
ANDEAN PACT	1.8	4.0	4.5	0.7	1.06
CACM	25.5	23.3	11.6 b/	0.1	0.17
CARICOM	6.2	4.3	5.5 a/	0.2	0.01
ECOWAS	3.9	1.0	3.8 a/	0.6	0.6

Source: UNCTAD secretariat calculations.

a/ Refers to 1987.

b/ Refers to 1986.

c/ Excluding socialist countries of Eastern Europe.

B. Integration experiences of EFTA, CMEA and developing countries

1. European Free Trade Association (EFTA)

10. The six EFTA countries 3/ have a free trade area among themselves and are essentially a trade grouping without any major supra-national institutional arrangements. Each member retains a separate trade régime with the rest of the world. These régimes are relatively open and liberal and hence do not pose the same degree of difficulties regarding access to their markets by third parties. Since 1972, when EFTA member countries became linked in a series of free trade agreements with the EEC, these two groupings have together constituted the largest free trade area in the world. Lower growth in intra-EFTA trade during the 1980s as compared with overall growth in trade over the same period had resulted - contrary to the experience of EEC, Canada-United States and CMEA - in a modest decline in the relative importance of its intra-trade (tables 1 and 2). Given the size and importance of EFTA's trade in manufactured products with the EEC, the moves towards completion of the internal market in the EEC poses a variety of policy choices for EFTA countries. The EEC 1992 Programme may affect the current symmetry in which EEC and EFTA have comparable access to each other's markets: this may be replaced by a situation in which EEC nations would have relatively better access to EEC markets than EFTA nations do. 4/ The response of EFTA has been to attempt to avoid this outcome by matching intra-EEC moves to complete its internal market with new negotiations on elimination of remaining obstacles to trade between EFTA and EEC countries. These negotiations have revolved around overcoming technical barriers to trade, such as standards and technical regulations, simplifying rules of origin, and improving adminstrative and customs procedures.

2. Council of Mutual Economic Assistance (CMEA)

11. CMEA is an economic grouping formed by the socialist countries of Eastern Europe in 1949 with the objective of accelerating economic growth and establishing a more rational division of labour among member countries. 5/ Most of the CMEA member countries are not contracting parties to the GATT. The major focus of CMEA's work has been in the areas of improved co-ordination of planning and co-operation in production, particularly in the areas of industrial policies and foreign trade. Since there are no tariffs on trade between member States, the principal impediments to the expansion of trade among them have been the absence of comparable prices, inconvertible exchange rates and differences in standardization. As a result, trade between countries members of CMEA is conducted essentially on the basis of quantitative bilateral exchanges.

12. In the 1970s, faster growth in trade with the rest of the world resulted in a significant decline in the relative importance of intra-CMEA trade. In the wake of the decline in external markets during the 1980s, its intra-grouping trade rose noticeably, indicating a general narrowing in its trade options and requiring greater reliance on access to its traditional markets and trading patterns.

13. It has become increasingly clear that the objectives of greater integration and specialization have proved difficult to secure in the absence of greater convertibility: the inter-CMEA clearing mechanism - the transferable rouble - has not evolved as a full-fledged convertible currency,

a requirement of particular importance to smaller economies within the integration arrangement, given the substantially greater importance of foreign trade for their economies. It could be also argued that administered prices and the essentially bilateral character of exchanges have themselves served as an impediment to convertibility. The use of administered prices has, among other things, contributed to a rigidity in trading relationships and to a reinforcement of bilateralism and a high degree of trade diversion.

14. Specialization in certain sectors of industry is the area where CMEA has had its most positive results. Serious economic and financial problems in the 1980s, however, have caused difficulties in the co-ordination of objectives and adjustment measures necessary to sustain recovery. It remains to be seen how trade policy reforms in progress, which emphasize greater integration with the international trading system, will affect the integration process of the CMEA as a whole.

3. Developing countries' experience

15. As is evident from tables 1 and 2, the process of economic integration among developing countries has experienced a set-back during the 1980s, as compared with the considerable progress recorded during the earlier period. Although the information in tables 1 and 2 is based on a selected sample of developing-country arrangements, the experience can be generalized for the majority of such groupings. It should be noted that since the late 1950s, over 40 economic co-operation groupings and arrangements have been established in Africa, Asia and Latin America 6/ with varying degrees of formality, coverage, and goals for integration. The experience with the process of economic integration is periodically reviewed in UNCTAD, both by its Committee on Economic Co-operation among Developing Countries, the most recent of which took place in June 1989, 7/ and by the Meetings of Heads of Secretariats of Economic Co-operation and Integration Groupings of Developing Countries, the most recent of which met in early 1989.

16. The main conclusion which may be drawn from the review of these experiences is that stresses in developing-country groupings have in most cases led to a set-back in the objective of enhancing integration among them. An important causal factor has been the adjustments which many member countries of economic groupings undertook in response to the crisis of the early 1980s. These adjustments led many of them to resort to short-term defensive measures which have exerted longer-term implications for both their partners in the various integration schemes and for the schemes themselves. The adoption of restrictions on trade and payments appear to have affected partner countries more severely.

Chapter II

EEC 1992 PROGRAMME AND THE CANADA-UNITED STATES FREE TRADE AGREEMENT: MARKET ACCESS ISSUES

A. Introduction

17. These two arrangements, relating to entities having a major weight in the world economy, are different in their objectives and their modalities. The Canada-United States Free Trade Agreement (FTA) aims mainly at liberalizing trade between the two countries and also includes some provisions on investment. The objective of the EEC 1992 Programme is not just to remove conventionally defined obstacles to the movement of trade, but also to improve the functioning of markets. The 1992 Programme goes much further than the Canada-United States FTA for factors of production, aiming at the removal of formal restrictions and further relaxation of regulations that obstruct their movements.

18. The Canada-United States FTA does not imply a common external policy and, therefore, its implications are principally indirect. The EEC has always had competence to set a common policy on trade in goods with the rest of the world. Its direct effect on the international system will be more immediate, as an increasing number of previously national negotiations become collective.

B. The EEC 1992 Programme, Access to Markets and Developing Countries

19. At this stage it is hard to be precise about the impact of the EEC 1992 Programme on the developing countries. First, the internal gains and the external impact of the Programme depend critically on the response of the EEC economy to the opportunities that integration will provide. Secondly, crucial decisions about how the programme is to be implemented have still to be taken. A number of directives in the 1992 programme have still not been tabled by the Commission, including some areas of interest to the developing countries. Thirdly, there is a methodological problem of distinguishing 1992 effects from the continuing effects of the presence of the EEC; from the effects of other changes in the EEC, notably the entry of the most recent members, Greece, Portugal, and Spain; and from other changes in international policy and other international negotiating processes, such as the Uruguay Round, renegotiation of MFA and Lomé IV.

20. Paragraphs 22 to 50 below review the impact of 1992 on the EEC imports from the developing countries in terms of, first, trade creation and trade diversion, 8/ and second, the elimination of member State quantitative import controls, the harmonization of indirect taxes, the establishment of EEC-wide standards and the concern that some of the burden of adjustment to the more competitive post-1992 climate will be shifted to exporting countries outside the Community.

21. The concept of a single market is founded on the belief that the Community must make a quantum leap in productivity and competitiveness if it is to compete effectively with other major trading countries, particularly the United States and Japan. But this also means an improvement in competitiveness vis-à-vis developing countries. Other things being equal,

this would mean a further redirection of trade away from traditional suppliers and towards partner EEC members, analogous to the redirection that occurred after the initial elimination of internal tariffs. This is the trade diversion effect of 1992.

1. EEC imports from the developing countries

22. The present structure of EEC imports is more the outcome of a complex set of preferential and protective interventions in trade than of the free interplay of international competition. The 1992 Programme to complete the internal market will have important implications for these interventions and hence for the structure of Community imports, including those from the developing countries.

23. First of all there are the internal barriers which the 1992 Programme is intended to eliminate. While imports from partner members within the EEC tariff-free market have risen in relation to those from the outside, in order to protect their own producers member States have often counteracted the effects of the customs union by preserving, or erecting, barriers to intra-EEC trade. The goal of the 1992 Programme is a unified trading region in which these barriers will no longer inhibit the movement of goods, services, people and capital throughout the Community.

24. Secondly, EEC's protection in agriculture, steel, textiles, chemicals, footwear and, recently, consumer electronics has limited the role of free international competition. To the extent that this protection is based on instruments adopted by individual member States, it is incompatible with the elimination of intra-Community border controls. If 1992 is to be associated with a rise in protectionism by the Community, existing member State import restrictions could be replaced by much more stringent restrictions on access to the Community market. However, should an open and liberal approach prevail, the world trade would be given a substantial new impetus and the export possibilities for developing countries would be enhanced.

25. Thirdly, the structure of EEC imports reflects a complex of preferential arrangements based on historical trading patterns. These arrangements cover the ACP States and the EFTA countries (which have duty-free access to the Community for their manufactures), the beneficiaries of the generalized system of preferences with their tariff preferences, and the Mediterranean countries with a network of special arrangements. In addition, trade is either closely managed with a host of restraints in respect of specific countries/territories or is largely agricultural and subject to the variable levies of the Common Agricultural Policy, or it is minimal and subject to no such restraints. This complex system of preferences is presumably going to outlive 1992 but it will continue to have implications for the impact of 1992 on the developing countries.

2. Implications of 1992 for developing countries' manufactured and semi-manufactured exports to the Community

(a) Trade diversion and trade creation

26. The extent of trade diversion and creation may be expected to depend, in the short- to medium-term, on the range of goods currently being exported to Europe. Thus for mineral and agricultural raw materials which cannot be

period beyond 1992. Determined efforts need to be made to ensure that the realization of the Programme imparts dynamism to world trade and enhances the trade and development possibilities of developing countries rather than having the opposite effect.

81. The run-up to 1992 coincides with the intensive phase of the Uruguay Round of multilateral trade negotiations and the beginning of the implementation of the results, the renewal of the Lomé Convention and the likely replacement of the fourth Multifibre Arrangement in mid-1991. Inevitably, the outcomes of these developments will be to some extent interrelated. The effects could be benign if the Uruguay Round negotiations were to produce additional across-the-board tariff cuts in goods of particular interest to the developing countries, including raw and processed tropical products, and measures in the areas of NTBs to compensate for difficulties associated with 1992.

Canada-United States Free Trade Agreement

82. The Canada-United States Free Trade Agreement (FTA), which became operational on 1 January 1989, incorporates several innovative provisions covering dispute settlement, foreign direct investment, services (including financial services), tariffs, prohibition of some NTBs and some restrictions on the use of safeguard measures.

83. As a free trade arrangement, the Canada-United States Agreement does not require common external barriers or policies directed against third parties, and consequently it is unlikely to affect existing arrangements with them, such as the Caribbean-United States Agreement.

84. At the aggregate level the trade-diverting effects of the FTA on the merchandise exports of the rest of the world in general are likely to be small because tariffs and other trade barriers between the two parties to the Agreement are generally already very low. The trade-diverting effects of the FTA are likely to be greatest in the case of labour-intensive products because these products tend to have the highest tariffs between Canada and the United States. Developing countries are likely to suffer from trade diversion more than other countries because the bulk of their manufactured exports to the United States and Canada is precisely in those categories subject to high tariffs. Among the developing countries, those most likely to experience trade diversion are the fast growing exporters of manufactures, because it is principally these developing countries that export manufactures to North America. Developing countries' agricultural exports to Canada and the United States will be unaffected to the extent that the FTA did not resolve the issue of agricultural and related subsidies.

Systemic implications

85. Article XXIV of the GATT provides the basis for the establishment of customs unions, FTAs, and interim arrangements leading to the two. The application of this Article, which has been replete with ambiguities in its interpretation, has permitted a wide degree of latitude. Its strengthening in the direction of its original intent - i.e. to ensure that agreements do not raise barriers to third-country trade, to improve arrangements for notification, and to provide for rigorous monitoring and reviews prior to the

produced in the Community, trade creation will be dominant. However, demand for primary commodities does not respond as much to increase in income as does demand for manufactures. On the basis of a number of econometric estimates of the elasticities of import demand for primary goods and the assumption that 1992 will boost EEC GDP by 5 per cent (which is roughly in the middle of the range estimated in the Cecchini report), 9/ it has been calculated that EEC imports from the developing countries will rise by just over $5 billion. 10/ This amounts to about 6 per cent of the value of existing exports.

27. Matthews and McAleese qualify these estimates in terms of uncertainties over the elasticities and, in particular, arguments which suggest that the 1992 process will itself affect the demand elasticities. In particular, the magnitude of the trade creation depends crucially on the elasticity of demand for fuel imports - indeed about 80 per cent of the gain is made up of fuel imports. The EEC's fuel imports come from a geographically limited number of countries; the gains to other exporters consequently will be considerably smaller.

28. The Commission estimates the direct effect of the removal of barriers, mainly through the elimination of customs procedures on internal trade and the opening up of public procurement, as a reduction in manufactured imports from the rest of the world of some 10 per cent. However, the Commission's study of the sectoral impact of 1992 did not make estimates of trade diversion arising from the dynamic effects, the economies of scale and other technical efficiencies from restructuring, and other effects of enhanced competition. 11/ How much these indirect effects will redirect EEC purchases from developing-country suppliers to EEC suppliers is a matter for speculation. To the extent that redirection is concentrated on products with potentially large economies of scale, this import replacement effect will be felt most acutely by other developed countries. The manufactured exports of the developing countries are largely in clothing, footwear, leather goods, electronic components and toys, where economies of scale are limited. However, significant replacement could take place in steel and steel products, other metal products, chemicals and fertilizers.

29. The Commission study argues that the 1992 programme will boost EEC GDP by 4.5 to 7 per cent, depending on the accompanying policies adopted by the member States. Taking an import elasticity of 3, the trade-creation effect on developing countries' manufactured exports of, say, a 5 per cent increase in Community GDP would be about 15 per cent. 12/

(b) Effects of eliminating article 115: the Multifibre Agreement (MFA)

30. The quantitative restraints (QR) on imports must be separated into those established under the umbrella of the MFA and the panoply of other QRs which have been set up independently by the member States, in some cases before they joined the EEC. In both cases, they depend to varying degrees on the use of article 115 of the Treaty of Rome, which allows member States to suspend free circulation of goods within the Community where outside exporters are circumventing, or threatening to circumvent, member State quotas by trans-shipping goods through another member State. It will no longer be possible to resort to article 115 once internal border controls are removed.

31. The present Community's bilateral arrangements under the Multifibre Agreement are particularly complex in that the quotas are generally subdivided into EEC member State shares. These quotas under MFA and non-MFA bilateral agreements cover the imports of up to 93 products from 17 developing countries and territories and 5 socialist countries. 13/

32. If the member States' shares (or subquotas) are to be abolished following the completion of the internal market and the EEC quotas retained without adjustments, then some liberalization is likely since each exporting country could utilize its EEC quotas more intensively. At present, certain subquotas remain under-utilized, but there are restrictions on the extent to which an unused portion can be transferred to a member whose quota is filled. The countries most likely to gain from the elimination of member State subquotas are those where current utilization of Community quotas is low but utilization of the subquotas is high. In respect of textiles, however, much will depend on the future of the MFA, which is at present under consideration in the Uruguay Round.

(c) Effects of eliminating article 115: other quantitative restrictions

33. The extent to which individual member States' quantitative restrictions will be "communitized", after post-1992 is, at this stage, uncertain. Aside from some export volume gain to MFA exporters referred to earlier, gains are likely to accrue through the removal of a number of member States' quotas and voluntary restraint arrangements (VRAs) on several other products. To the extent that export gains are offset by losses of quota-rents, the net effects would be smaller. The one area of concern relates to the extent to which industrial lobbies in the Community will succeed in arguing for replacing individual member-State quotas by a Community-wide export restraint arrangement covering all members. Replacing existing bilateral quotas by EEC quotas would mean extension of protection, since imports into all 12 member States would be covered. The products most likely to be affected are footwear, consumer electronics and ceramic tableware.

(d) Bananas: a special problem

34. At present about half of the Community's consumption of bananas is supplied by the associated ACP States and the Community itself (the French overseas Departments, Guadeloupe and Martinique), while the other half consists of "dollar" bananas, mostly from Central and South America. The former half enters the Community under special arrangements designed to preserve traditional markets. 14/

35. Although the ACP producers enjoy a 20 per cent tariff preference over producers of "dollar" bananas (except in Federal Republic of Germany where the latter enter duty-free), it is unlikely that they could compete without the guaranted access. Most of the protected producers are small-scale and relatively inefficient and, given their topographical disadvantages, even with major restructuring of the industry, their costs would remain considerably higher than those of the large plantations of Central America, Colombia and Ecuador. Commission officials have repeated commitments to maintain preferential access for the traditional suppliers after 1992 but the current preferences margin is unlikely to be adequate to sustain their exports.

(e) Harmonization of technical standards

36. Concern has been expressed that certain developing country exports will be unable to meet new EEC standards which may be higher than those currently in force in certain member States. 15/ For most products, however, the 1992 requirement will be mutual recognition among member States. Domestic producers are not subjected to testing or certification procedures, and exporters from outside will only have to satisfy the requirements of one member State and any tests they are subjected to and certificates of conformity will be valid throughout the EEC. However, to the extent that outside producers will be required to obtain the tests and certificates, they could come up against delays imposed by customs officials who will have to determine whether a particular shipment is covered by a certificate issued by another member State.

37. For agricultural goods the main directives which concern imports from third countries on plant health, animal diseases and "human health relating to animal products" have been in place for some years. But 1992 will bring some changes. The elimination of customs posts will mean that all inspections will have to be carried out at the first Community port of entry and there will be pressures to tighten inspections in the lax member States. The higher standards that are going to be instituted are most likely to impinge on exporters of planting material and cut flowers.

(f) Harmonization of tax régimes in the Community

38. In this area, the proposal is that all member States' VAT and excise tax rates should lie within agreed bands. Excise taxes will be limited to alcoholic drinks, tobacco and mineral oils. As regards coffee, for example, excise taxes in some member States are substantial, reaching 41 per cent in the Federal Republic of Germany and 15 per cent in Denmark. There will be important consequences for coffee exporters even though demand tends to be rather insensitive to price. It has been estimated that abolishing excise taxes on coffee would lead to a 3 per cent rise in Community imports, a 5 per cent increase in world prices and an additional $US 500 million in earnings on coffee exports to the Community. 16/ All exporting countries would benefit, with Brazil, Colombia and the Côte d'Ivoire the main gainers. Eliminating excise taxes and setting an average VAT rate of 5 per cent on cocoa would generate additional imports of about $US 28 million. The elimination of excise taxes on bananas in Italy will help Somalia, if it continues to supply the bulk of that market's needs.

39. Tobacco is a special case. Duties on cigarettes in the most popular price category range from 0.12 ECU in Spain to 2.76 ECU in Denmark. In response to the concern about the loss of revenue and health concerns in certain member States, the Commission has withdrawn its proposal that duties be aligned with the EEC average. Instead, excise rates will gradually be harmonized upwards, with negative consequences for the developing-country tobacco exporters. If, for example, tax rates were to be aligned on the average of the four States with the highest rates, the EEC average tax would almost double, implying a 40 per cent rise in prices. This could mean a reduction in EEC imports of between 10 and 15 per cent and a loss in developing country export earnings of $US 55 million to $US 85 million (based on 1987 imports). The damage to the exporters could be alleviated through a liberalization of the CAP tobacco régime and thus an end to EEC sales of low-quality tobaccos on the world market.

3. External trade policy

40. The 1992 Programme will undoubtedly accelerate the process of structural change through the loss of Article 115 of the Treaty of Rome, through increased labour mobility and through broad industrial rationalization and relocation. Thus, it could well generate pressures for shifting the burden of internal adjustment on to imports and restricting competition from outside.

41. The recent rise in anti-dumping investigations suggests that 1992 17/ may have already intensified resort to this instrument. Like voluntary export restraints, anti-dumping actions can be applied without going through the national legislatures or attracting much public attention. EEC industry may continue to pressure the Commission, with support from sympathetic member governments, to deal with any perceived advantages that 1992 may give to outside producers by using various instruments for restricting their exports.

42. Under the Community regulations on anti-dumping, these actions present a particularly effective way of tackling post-1992 adjustment problems and imposing the costs of adjustment on to the outside world. Anti-dumping actions can be effected quickly. Indeed, provisional duties can be imposed immediately. Decisions about which complaints should be pursued are primarily in the hands of the Commission. Depending on the outcome of investigations, a definitive duty is imposed or negotiations with the exporting firm are opened to elicit the appropriate response in the form of a price undertaking or a voluntary restraint arrangement (VRA) or both.

4. 1992 Programme and trade in services

43. The direct effects of 1992 on services are likely to result in faster growth in services trade among the EEC countries. Any directly trade-related services (shipping, insurance, financial, marketing and distribution) are likely to move with trade. Many of the barriers to trade which are to be lowered are those which are closely associated with trade-related services, so that lowering the relative price of intra-community traded services relative to extra-community trade is an essential part of 1992. Although there has been some EEC intervention in the past in intra-community and external trade in services, notably in transport because this is so closely tied to trade in goods, the 1992 Programme marks an important transfer to EEC competence, internally and externally. Favourable effects on third countries might come from very income-elastic services and the transitional advantages of scale from the completion of the single market.

44. For all forms of transport, the opening of the internal market is unlikely to permit foreign suppliers greater opportunities for intra-EEC transport: the existing conditions for access through the International Air Transport Association (IATA) and liner conference agreements and on permits for road transport effectively restrict outside suppliers. In aviation, there is clearly potential for economies of scale from mergers among European companies which could increase their competitiveness outside the EEC, thus causing a steep gain against other suppliers. In the long run, as transport is trade-related, the conclusions for the net effects on non-EEC suppliers will follow directly from those for goods. As the most price-competitive suppliers, developing countries in a position to provide this service would benefit more than other outside suppliers if these effects are positive. Sectors in which developing countries could benefit include tourism and data processing.

5. 1992 Programme and investment

45. Removing barriers to capital flows and improving information to permit companies to treat the EEC as a single market are central to the Programme, and, as in services, the next few years will see the effects of initial adjustment to a new régime. Trade-diversion effects will have immediate consequences for goods-related investment. The obvious consequence is an increase in investment in the EEC by those currently trading within the EEC, and a decrease elsewhere by those currently exporting to it. But there could be a substantial adjustment effect of traders moving into the EEC because of the reduction in cost from operating within the integrated market for goods and services. In addition to these effects will be those from the relative rise in the level and growth of demand, and from the opening of the market for financial and other investment-related services. The rise in inward-flow of investment into the EEC may represent some diversion from developing countries, although there is little evidence at present to suggest that this has so far taken place.

6. Concluding observations

46. Since its inception, the performance of the EEC and its impact on the pattern of international trade have been the subject of extensive empirical analysis. At least up to the first enlargement, EEC's trade performance had been broadly trade-creating and had been a source of dynamism in international trade. The process of unification of Europe has increasingly shifted the trade policy-making and the related apparatus for monitoring from the national entities to the Commission - a process which 1992 and the recent legislative changes in favour of majority decisions will intensify. Consequently, the further evolution of the Community will be the subject of intense interest for third parties in so far as it results in further changes in the way external trade policy issues will be formulated and conflicts resolved. Experience with the Common Agricultural Policy (CAP) is highly relevant in this regard.

47. CAP is one area where the EEC has gone furthest in establishing a common policy. The decision-making process may have contributed to prices - and levels of protection, levels of import barriers and in many cases export subsidies - gravitating towards the position of the most protective régime. The principles, techniques and devices developed to carry out CAP, in conjunction with the decision-making process that has evolved, have had an impact on the international trade relations.

C. The Canada-United States Free Trade Agreement (FTA)

48. After several years of negotiations, the Canada-United States FTA became a binding obligation for both countries on 1 January 1989. Consequently, the trade-diverting or creating effects of the FTA on developing countries can be assessed only on the basis of indirect and qualitative evidence and of possible patterns of trade: the analysis of these and other effects in subsequent discussions is, therefore, largely indicative. The major provisions of the FTA of strategic interest are the following:

(a) The Agreement provides a unique framework for settlement of disputes; it provides for a bilateral mechanism with binding powers as an alternative to judicial review by domestic courts.

(b) The issue of foreign investment has been wedded to the issue of freer trade in so far as the process of securing direct foreign investment (DFI) is now regarded as dependent on access by investors to a market that only freer trade can ensure is large enough.

(c) Canada has agreed to a more liberal treatment of United States companies in the areas of services (financial and non-financial) and direct foreign investment. Nevertheless, safeguards are built into the FTA in the areas of services and DFI.

(d) Existing discriminatory policies and restrictions affecting both trade in services and DFI are grandfathered (allowed to last in perpetuity), although future policies and regulations must be consistent with the principle of "national treatment".

(e) The FTA prohibits the imposition of performance standards on investment related to trade, such as export targets, import substitution, or domestic content. Nevertheless, the FTA permits the imposition of other forms of performance standards on foreign companies; for example, standards related to technology transfer and research and development.

(f) Certain sectors (basic telecommunications, transportation services, and cultural industries) are altogether excluded from the DFI provisions of the Agreement.

(g) Both the Canadian and the United States Governments are committed to liberalizing their financial markets. In this spirit, the FTA will free United States-owned banks and other financial institutions operating in Canada from most of the current restrictions on market share, asset growth, and capital expansion imposed against similar institutions from third countries.

49. Thus, the FTA removes many barriers to United States investment in Canada, but leaves intact strategic controls. Canada did not get a complete exemption from United States law concerning countervailing and anti-dumping duties. It was hard to develop a set of agreed rules on subsidies that would have resulted in the removal of countervailing duties in bilateral trade, despite the fact that most industries in both countries receive subsidies that amount to less than 1 per cent of the value of production.

50. The FTA originated primarily at the behest of Canada, which appears to have traded off some loss in control and ownership of domestic industry for improved access to the United States market. 18/ Since the average tariff barriers on trade between the United States and Canada are already quite low, and the United States sees its comparative advantage lying more in services, finance and agriculture rather than manufacturing, Canada's secure access to the United States market for its manufactures was contingent on granting concessions in areas of importance to the United States.

1. The measurement of the impact of the FTA on the direct parties

51. The prospect of freer trade between Canada and the United States has generated a large number of econometric studies to estimate the welfare effects of both countries. 19/ In some studies an attempt is made to estimate the impact of the Agreement, and other counter-factual trade concessions, on the rest of the world. These studies have resulted in more sophisticated

methods to estimate trade creation and now include the effects of scale economies, imperfect competition, and capital mobility. Although the studies do not allow for the effect of the greater security that comes from an agreed set of rules by trading partners, or attempt to measure the effects of freer trade in services, they still represent considerable improvement in the quantitative methods of empirical investigation.

52. The Canadian Department of Finance (1988) has used an updated version of the 1984 Cox and Harris model. 20/ The benchmark input-output data set is for 1981 and trade barriers extant in 1987. Of all the econometric exercises, only this one is modelled on the actual FTA. It estimates that the FTA would result in a significant real income gain to Canada of at least 2.5 per cent in the long run. As much as 80 per cent of the estimated real income gain is due to the exploitation of increasing returns to scale.

53. Virtually all econometric investigations indicate that the trade-related gains from the FTA for the United States are likely to be small. Instead, the United States appears to see itself gaining from the FTA in benefiting from new areas in which it has comparative advantage and in the form of setting a precedent. The precedent puts services, direct foreign investment, and other non-traditional issues on the agenda for negotiations, going beyond the usual issues of trade liberalization.

54. The various welfare estimates notwithstanding, it is still possible to argue that all recent measurement exercises of the FTA understate gains in welfare to Canada - the smaller of the trading partners - because they ignore the security that Canada gains from an agreement that clearly specifies the bounds of acceptable and unacceptable conduct of trade relations, and allows Canada more secure access to the United States market. The lower bounds of freer trade that would apply in times of economic depression have not really been clearly specified. Since, Canada does not enjoy "a complete exemption" from, or removal of, United States law as it relates to countervailing and anti-dumping duties, it still operates in its trade relations with the United States with a considerable degree of uncertainty.

2. Trade diversion in traditional consumer goods industries

55. Canada and the United States both had low average trade barriers against each other's manufactured goods as an initial condition. Canada imported mainly from the United States and the United States's imports in relation to its consumption is relatively lower. Therefore, it appears reasonable to suppose that trade diversion as a consequence of the FTA between Canada and the United States would be minimal.

56. However, although trade diversion as a result of the FTA may be small in the aggregate, it will probably be significant in the case of specific industries, particularly textiles, defined to include clothing and apparel. The textiles sector warrants greater discussion both because its value is high in terms of imports from developing countries by Canada and the United States, and because trade diversion may be expected to be particularly significant in this sector. For theoretical reasons, trade diversion may be expected to be especially high in cases where initial tariffs are relatively high, purchases

are high from the rest of the world relative to purchases of domestic goods, and the proportion of trade with the partner country relative to the rest of the world is low. Textiles, and apparel in particular, fill all three of these conditions.

57. The following discussion focuses on the degree to which Canada substitutes United States goods for third-country goods, rather than the degree to which the United States substitutes Canadian goods for third-country goods, because overall tariff levels tend to be relatively higher in Canada than in the United States, and the United States market is so large that Canadian diversion in traditional consumer goods as a result of the FTA is likely to have a relatively small impact on other countries' exports to the United States.

58. Agricultural products have been excluded from the discussion because they do not figure prominently in the FTA. Trade in agricultural products between the United States and Canada is characterized more by NTBs than tariffs. The FTA, however, was unable to resolve the long-standing differences between Canada and the United States concerning agricultural NTBs. Mention, however, should be made of the fact that the FTA does call for tariff reductions on agricultural products. These may impact on Canada's imports of vegetables and fruits, in particular from developing countries, mainly Brazil, Chile, Mexico, Ecuador and Costa Rica. Currently, developing countries account for roughly 20 per cent of Canada's fruit and vegetable imports whereas the United States accounts for approximately 65 per cent.

59. Existing barriers to trade in manufactures between the United States and Canada relate mainly to tariffs. According to estimates made by Canada's Department of Finance, tariff rates in 1987 averaged 4.5 per cent in Canada and accounted for three fourths of total price protection in goods-producing industries. By comparison, the United States tariffs averaged 2.8 per cent and accounted for three fifths of the price protection in goods-producing industries. The Canadian Department of Finance estimates that total protection provided by tariffs, quantitative restrictions, and federal procurement combined was the tariff-equivalent of 6.1 per cent in Canada and 4.7 per cent in the United States. 21/

60. Nevertheless, total protection was far higher in certain industries, which tended to be the same in Canada and the United States and in which were concentrated the high volume of imports from developing countries. The highest duty rates in both the United States and Canada apply to the same products: apparel and textiles. What is more, apparel constitutes Canada's single most important and manufactured import from developing countries, accounting for 23.6 per cent of the total. Thus, a close examination of tariff rates suggests that whereas trade diversion in aggregate terms may turn out to be unimportant in the Canadian case when imports from developing countries are considered, it may be significant for particular manufactured products, and these products tend to be major developing country exports to Canada.

61. What is more, apparel is singled out for discrimination in the FTA with respect to rules of origin regulations. In general, products qualify for free trade between Canada and the United States no matter where they are produced, if at least 50 per cent of the value of the materials and processing embodied

in them originates in either the United States or Canada. In the case of apparel (and other selected products), however, rules of origin are more restrictive. 22/

62. Apparel is one of the "managed trade" sectors that is subject to restrictive rules of origin criteria. The largest absolute gap in duty rates between the United States and Canada applies to apparel and textiles, while the next largest gap applies to transportation equipment, which is also subject to extra restrictive rules of origin. Thus, apparel from developing countries, unless it is made with fabrics of United States or Canada will not qualify for free trade under the terms of the FTA. The extra restrictiveness of rules of origin applicable to apparel further increases the possibility of trade diversion.

63. The extent of trade diversion will depend on how differentiated are products by country of origin. To obtain a rough estimate of the degree of differentiation that exists, one may look at Canadian imports at the three-digit level and determine the relative percentages of imports in each three-digit category that originates from developing countries and the United States. As a rule of thumb, in those product categories in which both the United States and developing countries hold a significant share (say, greater than 10 per cent), trade diversion may be expected to occur. In the case of apparel, when trade data are broken down into seven 3-digit categories, in only two of these is the United States share greater than 10 per cent, and these categories account for a relatively small share of total apparel imports. Thus, by this rough criterion there appears to be a high degree of differentiation in apparel from the United States and developing countries, making it less likely that trade diversion will occur.

Chapter III

SYSTEMIC IMPLICATIONS OF REGIONAL INTEGRATION

A. Introduction

64. The growth in preferential trading arrangements, given the GATT commitments towards non-discrimination and adherence to the most-favoured-nation clause, has been the subject of growing analysis and interest, not only because of the movement towards the deepening in the process of integration of the EEC, and the establishment of the Canada-United States FTA, but also because of a variety of suggestions for the establishment of FTAs in the Pacific region and elsewhere revolving around the United States and/or Japan. The conjuncture of these moves has been a source of as much concern as the fact that they are taking place in parallel to the Uruguay Round of MTNs and during a period of continuing erosion in trading disciplines.

B. Article XXIV of the GATT

65. Although customs unions and FTAs are derogations from the GATT norms of non-discrimination and MFN, article XXIV of the GATT recognizes the desirability of promoting trade liberalization through "closer integration between economies of the countries participant to such agreements." Article XXIV outlines the conditions and criterion that such regional groupings would have to meet in order to be GATT-consistent. These include, among others, that detailed notification of the proposed agreement is given to GATT signatories (art. XXIV: 7(a)); the agreement does not raise barriers to third country trade (art. XXIV: 4) and that the agreement covers "substantially all" trade between the partner countries (art. XXIV: 8(b)).

66. The process of examining customs unions and FTAs is undertaken in Working Parties established by the GATT Council. A first requirement in this regard is for the parties to regional agreements to notify promptly the contracting parties of the formation of such regional groupings. The process of notification and the subsequent examination of the arrangement has provided a degree of transparency in the assessment of the implications of a regional arrangement and may have indirectly contributed to lessening the impact on third parties. However, since there is no requirement of pre-notification, the arrangements are presented as *faits accomplis*.

67. The *a priori* determination of which regional arrangements are beneficial or not has not been easy. In the face of the ambiguities surrounding the interpretation of article XXIV, the practice in GATT has been to extend a high degree of tolerance to a wide variety of trade arrangements. For example, while article XXIV discussions have been held quite frequently, they have yielded inconclusive results as regards the compatability of FTAs and customs unions with GATT rules. It has been noted that since 1948, out of a total of about 70 FTAs and preferential trade agreements which have been examined by GATT under the provisions of article XXIV, only four agreements are reported to have been considered compatible with article XXIV requirements. 23/ It is noteworthy that no Working Party to date has reached a unanimous conclusion in regard to arrangements involving the EEC. While parties to the regional

agreements deem the absence of conclusions or recommendations to amend the agreement as de facto approval by the Contracting Parties, third countries generally consider this as leaving the issue unresolved and hence subject to further review.

68. The question arises as to why article XXIV of the GATT has fallen into disuse. Aside from the widely noted ambiguity of its provisions, non-economic considerations have often outweighed other factors in GATT decisions concerning the terms of the agreements. Affected third countries have often been reluctant to criticize preferential arrangements, in part because they affect interests of key trading partners but also because some of them have themselves been engaged in similar arrangements. The ambiguities referred to earlier in article XXIV have allowed exceptions in the coverage of agriculture and other sectors in many agreements of which GATT has been notified. The expedient interpretation of article XXIV has been questioned by a Group of Eminent Persons. 24/ The report warned that "..... exceptions and ambiguities which have thus been permitted have seriously weakened the trade rules, and make it very difficult to resolve disputes to which article XXIV is relevant. They have set a dangerous precedent for further special deals, fragmentation of the trading system, and damage to the trade interests of non-participants."

C. Regional arrangements

69. The FTA approach has been the subject of intensive review, particularly in the United States where both the academic and the policy-making community have undertaken extensive analysis of the pros and cons of the United States engaging in FTAs with several candidate countries and territories, among them Mexico, Taiwan (Province of China), Republic of Korea, Japan, ASEAN and several other Pacific Rim countries. 25/

70. The principal reasons cited in favour of entering selective plurilateral or bilateral arrangements include: (a) desire to secure markets - or at any rate, as a minimum, to maintain present level of access; (b) dissatisfaction with multilateral approaches; (c) concern about trade deficits specific to the protagonists; (d) reduction of foreign trade barriers as a means of promoting liberalization of the trading system; (e) improved management of bilateral accords, including balancing of bilateral trade flows.

71. For a variety of reasons, however, these approaches are likely to be limiting in their effectiveness. In the first place, it is not certain that they hold significant promise of trade reform or liberalization. The principal concessions likely to be extended are in the area of tariffs. The more contentious issues - such as import licensing, public procurement, and a host of NTBs - particularly for some of the candidate countries targetted for FTA - are likely to be excluded. The experience with regard to the Canadian-United States FTA suggests that anti-dumping, countervailing duties and subsidy policy are also areas which are difficult to incorporate into bilateral arrangements.

72. Secondly, it is questionable whether some key areas can be addressed meaningfully at all in a bilateral context. The problems of subsidies, agriculture and structural adjustment which impact on trading patterns go beyond the concerns of countries directly affected and cannot be meaningfully addressed in a bilateral context. Even if specific aspects are satisfactorily

resolved in such arrangements, it is likely that they will contribute to increasing trade tensions with countries left out of such arrangements without necessarily addressing the underlying problems - both macro and micro - which gave rise to the desirability for instituting the FTAs in the first place. If policies and markets of other non-participating countries continue to contribute to trade distortions, then the establishment of an FTA or other similar arrangement would in effect leave out of the arrangements factors which would eventually bear on the effectiveness of the bilateral arrangement.

73. Since one of the objectives in the establishment of FTAs or other bilateral arrangements is that of redressing existing trade imbalances, the question arises to what extent they contribute towards meeting this objective. A sustained improvement may require, depending on the circumstances, complementary changes in macro-economic and exchange-rate policies by the respective trading partners. In conclusion, the FTA approach can have several risks: such arrangements could undermine efforts in GATT without yielding significant reforms. They may even reduce the momentum for tariff cuts by creating vested interests in the partner countries for the preservation of FTA-related preferences.

74. The impact of customs unions on international trade and trade relations has attracted much attention. A number of contemporary writers on the economics of integration, like Cooper and Massell (1965), Harry Johnson (1965) and Peter Robson (1984), argue that the most plausible rationale for the formation of customs unions is that they enable groups of countries to achieve more economically the objectives served by protectionism. 26/ The nature of the relevant decision-making tends to lead to the acceptance of the lower common denominator positions, which are often those held by the most protectionist participant. However, if the more liberal partners are able to sway the decisions closer to their policies, the resulting effects will certainly be favourable to liberalization.

Chapter IV

SUMMARY AND SOME POLICY ISSUES

75. The experiences of the developed and the developing countries in furthering regional economic integration have been markedly different: in the developing countries, most integration groupings have suffered a setback recently stemming from a contraction in their economic activity and external trade. The incidence of related adjustments has been disproportionately borne by integration arrangements and their members. In contrast, in the developed market-economy countries the integration processes have advanced in recent years.

76. The recent enlargement of the EEC, the deepening in the process of integration envisaged in the wake of the Single Europe Act (1987) and the coming into force of the Canada-United States Free Trade Agreement have raised questions about the impact of these arrangements on access to the corresponding markets and about their implications for the international trading system. The concern about market access stems from the possible trade diversion effects of these arrangements which, by their very nature, discriminate against third parties.

77. The systemic implications of such groupings arise not only from the economic and political importance of the countries involved but also from the concern that their proliferation may lead to a further erosion and possible fragmentation of the trading system and to a weakening of its disciplines. The effect of such developments would be greatest on smaller exporting countries, particularly developing countries.

EEC 1992

78. The Single Europe Act can be viewed as a decisive move towards the attainment of the objectives set out in the Treaty of Rome more than 30 years ago. The goal of the 1992 Programme is a unified trading region with the movement of goods, services, labour and capital between member States as free as movements within a single nation State.

79. The 1992 Programme to complete the internal market will have implications for the complex mechanisms of preferential and protective intervention by the EEC and hence for its imports. The immediate increases in EEC's output attributable to the 1992 Programme is likely to yield some export gains to developing countries in primary products. For their manufactured exports, the identifiable short-term effects of 1992 are rather small.

80. If, as has been argued in the Cecchini report, 27/ the completion of the single market leads - through intensified flows of innovation, new processes and new products - to a higher long-term EEC growth rate, then trade creation would predominate and developing countries could experience a long-term rise in demand for their exports to this area. There is, however, a danger of protectionist reactions to the adjustment problems, industrial relocation and regional unemployment which "1992" must bring if it is to achieve the predicted "shake out" in the EEC economy. The temptation to pass on the burden of adjustment is already manifest and may be expected to grow in the

establishment of such arrangements - could contribute to a better assessment of the consistency of such agreements with GATT rules. Article XXIV is among the numerous GATT articles which has been proposed for consideration and review in the Uruguay Round.

86. The interest of developed market-economy countries in bilateral accords and FTAs arises in part from their perception that the pace of multilateral processes is generally too slow, their scope limited, and multilateral dispute-settlement procedures inadequate and time-consuming. However, it is not certain that bilateral/plurilateral arrangements hold out any significant promise of trade reform or liberalization, since the principal concessions likely to be granted are mostly in the area of tariffs. Problems in areas such as structural adjustment, persistent trade deficits or surpluses, agriculture, subsidies, trade frictions, exchange rates and monetary policies affecting trade, are of a systemic character and could be resolved better in a multilateral context.

87. The assurances repeatedly given that integration arrangements, far from being inward-looking, would contribute to a more dynamic and open trading system, would be reinforced if the Uruguay Round of multilateral trade negotiations succeeded in strengthening the international trading system and improving overall market access for developing countries.

88. The major trading nations can help to assuage the concerns of developing and other trading countries by ensuring, through a rigorous review and monitoring of the provisions of their trade groupings, that they do not impede developing countries' access to their markets. The onus of confidence-building lies very much with the policy-makers of these arrangements. It may be useful to keep under review the experience gained in the operation of such arrangements and their impact on the export prospects of developing countries.

Notes

1/ For a brief review of these arrangements, see chapter I.

2/ See, for example, The Asian Development Bank, Asian Development Outlook, 1989, Manila, 1989, p.20.

3/ The present members are: Austria, Finland, Iceland, Norway, Sweden and Switzerland. When EFTA was first established, United Kingdom and Portugal were also members.

4/ See Paul Krugman, "EFTA and 1992", Occasional Paper No. 23, European Free Trade Association, June 1988.

5/ The CMEA has 10 full participating members: Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the USSR; the German Democratic Republic (joined in 1950), Mongolia (1962), Cuba (1972) and Viet Nam (1978) (Albania, which joined in 1949, has not participated actively in the work of CMEA since 1962). Yugoslavia is an associate member and seven other developing countries and one developed country are observers.

6/ For a description and composition of these groupings and their major objectives see "Index of economic co-operation and integration groupings of developing countries: membership and objectives" (TD/B/C.7/AC.3/3), 17 February 1989.

7/ Ibid.

8/ It has become the practice to use the term "trade diversion" to refer to the total displacement of imports from suppliers outside the EEC to those within, regardless of whether that displacement is directly occasioned by the elimination of intra-EEC barriers (trade reduction in the classical trade theory sense) or other 1992-related cost deductions in the EEC. Also the term "trade creation" refers to the increase in extra-EEC imports stimulated by the rise in EEC output or incomes - not in the strict trade - theoretic sense of intra-customs union trade stimulated by the price effects of removing barriers.

9/ P. Cecchini, The European Challenge, 1992, Aldershot: Wildwood Press, 1988.

10/ See A. Matthews, and D. McAleese, "LDC primary exports to the EC: prospects post 1992". Paper prepared for meeting organized by the Netherlands Ministry of Foreign Affairs, The Hague, October 1989.

11/ Commission of the European Communities, "The Economics of 1992" in European Economy, 35, Brussels, March 1988.

12/ See Michael Davenport, Overseas Development Institute Briefing paper, "The Developing Countries and 1992", November 1989. The author argues that "The Commission estimates the direct effect of the removal of barriers as a reduction in manufactured imports of some 10 per cent. Extrapolating to take account of economies of scale and other industrial rationalization on the basis of the Commission estimates of growth effects, this number should be raised to 15 per cent. Taking an import elasticity of 3, the trade creation effect on LDC manufactured exports, say, a 5 per cent increase in Community GPD would be of about 15 per cent. On balance trade creation and trade diversion in manufactures will probably offset each other".

13/ Several countries are restricted through different mechanisms. In particular Turkey and the North African suppliers are limited through their Association and Co-operation Agreements with the Community, but they are only subject to Community quotas.

14/ Thus the United Kingdom provides a guaranteed market for unlimited quantities of bananas from the English-speaking Caribbean and Suriname. France and Italy provide similar guarantees for the French overseas Departments, Cameroon and Côte d'Ivoire, and for Somalia respectively.

15/ In the area of meat products (mostly tinned meat) there are two potentially important directives in the pipeline. The meat product proposal will probably lead to a requirement for Community licensing of both slaughterhouses and processing plants in all third country suppliers. At present there is EEC certification of slaughterhouses in third countries which is required for exports of red meat to the Community, but some countries, such

as Ethiopia, currently export meat products but not red meat. The other is the expected framework proposal on food hygiene. Until the details are published it is difficult to determine what difficulties they may pose for developing-country exporters. Difficulties are likely to be limited to a few suppliers but could be of significance to the countries involved.

16/ For details regarding coffee, cocoa and tobacco, see Michael Davenport "European Community trade barriers to tropical agricultural products", ODI Working Paper, 27, Overseas Development Institute, London, 1988.

17/ The available evidence shows that the number of anti-dumping actions against the developing countries has risen significantly in recent years. Anti-dumping duties have been imposed on steel from Brazil and Mexico, Republic of Korea video cassette recorders and paint brushes from China. In the early 1980s actions against firms in the developing countries concentrated on chemicals, steel products and building materials. The actions largely affected the countries of South America. Since then the trend has been turned against exporters of high-technology products. High-technology products have taken a rising share of imports and, with that, anti-dumping proceedings over the last few years. Initially they were mainly directed at Japanese companies. Now actions are being increasingly aimed at the fast growing exporters of Asia. See Michael Davenport, "The Charybdis of dumping: a new EC industrial policy", Royal Institute of International Affairs Discussion Paper, Chathan House, London, 1989.

18/ See J.J. Schott and M.G. Smith (eds) "The Canada-United States Free Trade Agreement: The Global Impact". Institute for International Economics, Washington, D.C., 1988.

19/ See J. Whalley, Trade Liberalization Among Major World Trading Areas, MIT Press, Cambridge, Ma. 1985. Also see, Canadian Department of Finance, "The Canada-United States Free Trade Agreement", Ottawa, 1988 and D. Cox, and R. Harris "Trade Liberalization and Industrial Organization: Some Estimates for Canada", in Journal of Political Economy, v. 93 no. 2., 1985 and D. Cox and R. Harris, "Trade, Industrial Policy and Canadian Manufacturing", Ontario Economic Council, Toronto, 1984.

20/ A general equilibrium simulation model of free trade between the United States and Canada by Harris and Cox (1984) and Cox and Harris (1985), commissioned by the Ontario Economic Council, provided the starting point for an extended debate on the implications of the FTA. The Cox-Harris model produced welfare gains for the United States, and Canada expecially, that were extremely high by the standards of earlier studies. These findings were surprising because, at the time, three quarters of Canadian-United States trade was already free of trade restrictions and existing tariffs and NTBs in most industries were low, leading to the expectation that welfare gains as a result of further freeing of trade would be minor.

21/ Cited in Professor Alice Amsden, "Regional Trading Arrangements: The Impact of the US-Canada Free Trade Agreement on Developing Countries", mimeo, 1989.

22/ When two countries in an FTA have different external trade barriers, an incentive exists to route a product through the country with the lower external barrier and then re-export it duty-free to the country with the higher external barrier. This problem is known as "trade deflection". To prevent trade deflection, virtually all FTAs impose "rules of origin" criteria before products can qualify for duty-free access. Rules of origin can be more or less restrictive, depending on the amount of value added required to qualify for duty-free trade. When there are small discrepancies between the two countries in the levels of effective protection for particular activities, relatively modest value-added requirements are usually sufficient to prevent significant deflections of trade or production. But when discrepancies are large, strict rules of origin with higher North American content requirements are likely to be necessary. For most commodities, Canada and the United States have a very similar structure of external barriers, but significant differences exist or can arise, particularly in sectors characterized by a managed trade. (M.G. Smith, "A Canadian Perspective" in R.M. Stern, P.H. Trezise and J. Whalley (Eds.) "Perspectives on a U.S-Canadian Free Trade Agreement", Brookings Institution, Washington, D.C., 1987.)

23/ These four are: The South Africa Rhodesia Customs Unions (1948); Nicaragua - El Salvador FTA (1951); Nicaraguan participation in the Central American Free Trade Area (1958); and the Caribbean Community and Common Market (1973).

24/ See GATT "Trade Policies for a Better Future: Proposals for Action", GATT, Geneva, 1985, p.41.

25/ The proposal to study the pros and cons of a free trade agreement between the United States and Japan originated from a suggestion by the then United States Ambassador to Japan, Mr. M. Mansfield (the text of his statement on a United States-Japan Free Trade Agreement, dated 7 July 1988 is reproduced in "Pros and Cons of Initiating Negotiations with Japan to explore the possibility of a US-Japan Free Trade Agreement". Report to the Senate Committee on Finance on Investigation (No. TA - 332 -255) USITC publication 2120, September 1988, Washington, D.C. The Ambassador also referred to a number of studies already under way in Japan to analyse the implications of United States-Japan FTA and that with other countries in the Pacific region. See also "The Pros and Cons of Entering into Negotiations on Free Trade Area Agreement with Taiwan, the Republic of Korea, and the ASEAN or the Pacific Rim Region in General", Report to the Senate Committee on Finance on Investigation, No.TA-332-259 under section 332 of the Tariff Act of 1930, USITC Publication 2166, Washington D.C., March 1989.

26/ cf. G.N. Yannopoulos, Customs Unions and Trade Conflicts, Routledge, London, 1988.

27/ P. Cecchini, op. cit.